BCLP. Client Intelligent

Insights

SHOW ME THE CATO! FUNDING AND FINANCING - ONE FOLLOWS THE OTHER: VOLUME 3

May 13, 2016

SUMMARY

The third in a series of articles exploring the competitively appointed transmission owners (CATO) regime. This update details the revenue stream structure associated with these projects.

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).

In this, the third article of our introductory series on CATOs, (now that's what I call CATO: Volume 1, CATO - Better Late than never? Volume 2) we discuss the proposed revenue stream and incentives.

OFGEM'S POSITION

Ofgem's consultation proposes a 25-year revenue stream (with no periodic reviews and subject to partial indexation) in return for constructing and operating the transmission assets. As with the current position with asset investment in the RIIO-T1 period (up to 31 March 2021), consumers would pay for new assets over a 45 year cost recovery period.

As there is a difference between this period of cost recovery from consumers and the 25-year revenue stream, the CATO's asset would be partly depreciated over the 25-year revenue period, leaving a residual asset value. This residual asset value would then be recovered from future consumers.

Ofgem further proposes that there would be a gain share mechanism for debt refinancing and a mechanism for additional asset investment (for example upgrades and extensions).

Revenue is likely to commence once the project is constructed and operational, though there may be departure from this principle for (large) projects with long construction periods. The primary incentive structure proposed by Ofgem will be availability-based, with ten percent of annual revenue at risk from underperformance.

TENOR

Whilst senior project debt with a tenor of 20-25 years has been market standard and used for many infrastructure projects, extending the tenor beyond this length might potentially result in better value for consumers. While an extended tenor may limit the availability of bank financing, it may increase interest from institutional investors such as pension funds and insurance companies, especially as the revenue stream is (partially) indexed, thereby providing a wider pool of capital to provide finance for projects. Since capital markets financing solutions are more suited to funding large projects, it may be that projects could be banded by value such that longer tenors are available for higher-value projects (or smaller projects that are aggregated together to result in a combined value above relevant benchmarked thresholds). However, it should be noted that increased tenor length may potentially be difficult as a result of difficulty in fixing opex for these longer periods.

RESIDUAL ASSET VALUE

Regardless of the tenor length (as this will not match the 45-year asset cost recovery period), there will be a residual value to the asset at the end of the tenor. The residual value would (we assume) be paid to the outgoing CATO (subject to any deductions based on pre-agreed asset standards) in return for transfer of the assets - this payment potentially being raised by way of senior secured debt against the residual asset by the incoming CATO. Valuation and payment under this type of mechanism is likely to be supported by deductions from a (pre-agreed) residual value should the asset not have been maintained to the standard contracted to by the outgoing CATO.

Alternatively, Ofgem has suggested that, at the end of the tender period, the revenue term of the CATO could be extended for a fixed period, or the asset could be decommissioned if no longer required.

(PARTIAL) INDEXATION

Partial indexation may provide better value for consumers in that it will reduce the CATO's need for (and cost of) hedging instruments, whilst also reducing the risk of cost inflation-linked default. As with OFTOs, it is likely that tender participants will bid the proportion of the revenue stream that they require to be indexed. Whilst unlikely to be controversial, there may be some friction between the government's general move to consumer price index (CPI)-indexation, and that opex costs may be linked to RPI-indexation. The spread between CPI and RPI could, however, be managed through adjusting the proportion of revenue required to be indexed.

REFINANCING

Potential tender participants would be asked to accept a gain share mechanism on the refinancing of senior debt. The mechanism itself is also likely to be relatively uncontroversial given the established Treasury SoPC principles (but not 90:10!). The key questions, however, are: (i) the relative gain share as between the CATO and Ofgem, and (ii) the structuring of the mechanism such that it does not inadvertently prejudice certain finance structures that involve pre-determined refinancing (such as 'bridge to bond financing'). Ideally, CATOs should not be disincentivised from refinancing as a result of disproportionate gain shares, and a 50:50 share may be adequate to sufficiently incentivise refinancing when appropriate.

ADDITIONAL ASSET INVESTMENT

Ofgem acknowledges in the consultation that there will be the opportunity to invest in additional assets over the period of the CATO's incumbency via a licence condition and a mechanism to adjust the CATO's revenue. During the tender process, it is envisaged that tender participants would have to be able to prove the ability to finance additional investment (which is suggested as capped as a proportion of capex or an absolute value). This seems a practical and uncontroversial approach, though precisely how remuneration for additional assets will be calculated remains to be clarified.

PAYMENT ON OPERATION

A welcome potential introduction to the CATO structure (that was not part of the OFTO structure) is that Ofgem's consultation explicitly acknowledged a potential need to make interim payments for particularly large and/or complex projects. This would potentially prevent the issue of cost increases as a result of debt capitalisation throughout the construction period (and potential liquidity issues around delays and cost overruns). This said, the default position is likely to be payment on operation.

AVAILABILITY PAYMENTS (AT RISK)

The consultation suggests that performance is incentivised through availability payments. These would ensure that capacity is available, minimising outages and promoting efficient maintenance of the assets (as opposed to 'energy supplied' criteria, which may not be applicable to all CATO assets).

Similar to OFTOs, the proportion of annual revenue at risk as a result of underperformance would be capped at ten percent (10%). While it is certainly necessary to cap the proportion of revenue at risk to ensure a project is bankable, the precise level of this cap should be considered carefully. Whilst not wanting to introduce undue risk into the financing of projects, the level should be sufficient to properly incentivise performance of the CATO's obligations in all circumstances.

LOOKING AHEAD

The key principles of the revenue stream, many of which mirror OFTOs, are clear. However, the precise detail may have a significant effect on the attractiveness of CATOs to infrastructure investors. In particular, how any residual asset value is calculated will be crucial to the bankability of projects, whilst detailed proposals around refinancing should resolve any ambiguity such as not to unduly restrict certain structures (such as ‘bridge to bond’ financing).

The consultation responses have provided a wide range of views and we hope that Ofgem will take on board the issues around bankability and finance to facilitate the generation of an asset class that benefits from significant interest and competitive tenders resulting in significant value for money benefits for consumers.

RELATED CAPABILITIES

- Power
- Renewables & Storage

MEET THE TEAM

Mark Richards

London

mark.richards@bclplaw.com
+44 (0) 20 3400 4603

Alexander Hadrill

London

alexander.hadrill@bclplaw.com
+44 (0) 20 3400 4740

This material is not comprehensive, is for informational purposes only, and is not legal advice. Your use or receipt of this material does not create an attorney-client relationship between us. If you require legal advice, you should consult an attorney regarding your particular circumstances. The choice of a lawyer is an important decision and should not be based solely upon advertisements. This material may be “Attorney Advertising” under the ethics and professional rules of certain jurisdictions. For advertising purposes, St. Louis, Missouri, is designated BCLP’s principal office and Kathrine Dixon (kathrine.dixon@bclplaw.com) as the responsible attorney.

© 2025 Bryan Cave Leighton Paisner LLP.