

Response to RIIO-2 Draft Determinations for Transmission, Gas Distribution and Electricity System Operator

Summary

Balfour Beatty supports the objective set out in the draft determinations, of achieving value and lower bills for consumers. We also welcome elements of the draft determinations, such as the £6 billion which will be spent on maintenance and repair for aging infrastructure. However, we believe that the approach proposed in the draft determinations is unlikely to deliver the objectives of value and lower bills over the long-term. Indeed, in our expert view, over the long-term, the overriding focus on cutting gas and electricity bills by c.£20 a year per household would prove to be a false economy, in fact increasing the costs for consumers. They would also have a negative impact on decarbonisation, employment, skills and training, investment in innovation – which is vital to deliver a greener energy system - and on the small businesses which make up the construction and infrastructure supply chain, as we outline below.

Ofgem, as the independent regulator, has a duty to protect the interests of existing and future consumers, as set out in Part 1 of the Gas Act 1986 and Electricity Act 1989, and to deliver other priorities including decarbonisation. Balfour Beatty urges Ofgem to reconsider its position and to consider the long-term impact on bills, as well as the broader picture in terms of impacts on decarbonisation, employment and small businesses.

Balfour Beatty has recently announced its strategic withdrawal from the gas and water markets, which are no longer viable to the group because of unfavourable working capital clauses, inappropriate risk transfer (such as passing regulatory penalties to the supply chain) and contracts generally being offered on terms that are not acceptable to us. This situation has arisen, at least in part, due to regulators favouring cost reductions at the expense of supporting a sustainable supply chain that can invest in and develop skills and capacity for the future on the back of confidence in a future order book. We believe that other contractors share this view and some have taken similar decisions to withdraw from certain market sectors. Balfour Beatty has a long and proud history in and remains firmly committed to the power transmission and distribution markets but this can only continue to be the case for future generations if the client organisations are able to provide a visible pipeline that is appropriately funded.

Decarbonisation and a 'green recovery'

In order to meet the UK's net zero carbon targets at the lowest possible cost to customers, significant private investment will be required. Investors need policy certainty. The environment of uncertainty in the UK, teamed with halving the existing rate to one of 3.95% as set out in the draft determinations would reduce investment. This would be one of the lowest rates of return of any developed country, leading investors to look elsewhere in what is a competitive global market.

In our view, the rate set out in the draft determinations would therefore have an immediate negative impact on both the UK's ability to reach net zero by 2050 and the desired 'green recovery' from COVID-19. This approach essentially represents a short-term and very small cost reduction exercise for consumers rather than a balanced long-term sector position.

Balfour Beatty encourages a more strategic view to ensure long-term benefits to the consumer and the priority to decarbonise the economy.

Skills and employment

The measures outlined in the draft determinations would, in our view, hinder the creation of hundreds of much-needed new jobs, apprenticeships and other training opportunities in the sector. Ultimately, the tighter the financial settlement the energy companies are given, the more they are likely to return to lowest-price tendering and approaches which harm the construction and infrastructure industry and which reduce the social value being delivered which, in the current post-COVID-19 environment, has arguably never been more important.

For Balfour Beatty for example, if the level of determinations is maintained at a c.30-50% decrease on capital expenditure, this would have a material impact on our business and on our supply chain. In terms of the numbers of graduates, apprentices and trainees we take on in our transmission business for example, our projection is that it would result in a c.50% decrease rather than the increase in numbers we had planned. This is likely to be reflected across other companies.

The uncertainty and reduced investment in upgrades may mean that businesses operating in these areas have to downsize. Once this capability is lost, it is very hard to build back up again. Ultimately, the availability and quality of skills of those coming through will be a major factor in the sector being able to realise its potential growth and maintain its global competitiveness in the future.

Balfour Beatty and others are already looking for new talent to replace an ageing workforce, many of whom are looking to retire in the near future. The required skills profiles are evolving as we look to the future and roles requiring higher-level and digital skills grow in demand. We know that we may need engineers who can build a hydrogen network and technicians who can build and operate a flexible grid. We will also need a very different workforce on the power generation side if green/blue

hydrogen, small modular reactors (SMR), tidal and carbon capture and storage (CCS) take off.

Furthermore, this sector does not operate in isolation. There is a significant infrastructure pipeline, with schemes such as HS2 absorbing skilled workers. The construction and infrastructure industry is also in competition with a number of other industries, with engineering graduates and technicians highly sought after by other well-paid sectors, from financial services to logistics, making them a scarce resource. Contractors are making conscious decisions about where they deploy their people. Those schemes which allow contractors to make a reasonable margin are likely to be prioritised.

Not being able to invest in the talent pipeline and losing existing skilled workers to other infrastructure schemes and other sectors would result in demand for workers outstripping supply, potentially causing project delays. Wages would be driven up, which would have a knock-on impact on costs.

The supply chain and innovation

Balfour Beatty is concerned that, if implemented, the approach detailed in the draft determinations may destabilise the supply chain, which is largely made up of tier 3 and 4 suppliers - the small and medium sized companies which the wider UK economy relies on. While at first glance this may seem like a problem for individual companies rather than the industry as a whole, there is a mutual dependency on the supply chain which must be better understood. For example, the UK supply chain has been at the forefront of cutting-edge innovation. However, remaining so requires the ability to support the key drivers of investment in innovation and skills on a continuous basis: innovation to ensure current and future needs of customers are being met efficiently and that system operation is constantly being optimised; and investment in the skilled people needed to drive innovation and efficiencies and ensure capability and knowledge are maintained. This is especially the case in key areas such as new power generation and storage technologies, where the proving and developing of the technologies lies with private companies and the supply chains that support them.

Without a strong incentive to invest and innovate and with less available capital to do so, the current pace of innovation is likely to slow rather than increase, to the detriment of consumer bills over the long-term. Furthermore, some of the more complex projects (which generate the innovation) are likely to be shelved under the current determinations. This fall of in innovation will make it more difficult to address other priorities such as requirements to decarbonise and improve environmental outcomes.

The uncertainty mechanisms in the draft determination are of particular concern. These may result in contractors submitting tenders which are then subject to long delays before contract award or even no award at all. The work involved in producing such bids is significant and if there is a prospect of a scheme not

proceeding then contractors may not bid in the first place. The increased cost of tendering will need to be included in pricing models. Poor pipeline visibility and predictability are very damaging to the stability and long-term prospects of the supply chain. If project funding for large schemes is only finalised once the job is built this has the potential to generate commercial friction which is not value adding but disruptive to programme delivery. Furthermore it may prevent contractors from taking revenue and profit to their accounts under the current accounting standards which would be a significant disincentive to entering into such contracts.

Conclusion

Balfour Beatty believes that the calculation of c.£20 a year per household saving on consumer bills is likely to prove an optical illusion. The proposals set out in the draft determinations would reduce the investment needed to decarbonise the UK economy and drive up costs over the next few years and beyond. They also fail to take into account benefits such as employment, training and broader social value, which would all be lost if these proposals are implemented as currently set out. We urge Ofgem to rethink the draft determinations and to ensure that value is delivered through these proposals for future, as well as current customers.

About Balfour Beatty

Balfour Beatty ([balfourbeatty.com](https://www.balfourbeatty.com)) is a leading international infrastructure group. With 26,000 employees, we provide innovative and efficient infrastructure that underpins our daily lives, supports communities and enables economic growth. We finance, develop, build and maintain complex infrastructure such as transportation, power and utility systems, social and commercial buildings.

Our main geographies are the UK, US and Hong Kong. Over the last 110 years we have created iconic buildings and infrastructure all over the world including the London Olympics' Aquatic Centre, Hong Kong's first Zero Carbon building, the National Museum of the Marine Corps in the US and the Channel Tunnel Rail Link.