

DATACENTRE CONNECTIONS: OF BABIES AND BATHWATER?

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Ofgem is consulting on reforms designed to stop speculative data-centre projects clogging up the electricity connections queue. The problem it is trying to solve is real. A firm grid connection is increasingly valuable, and it makes little sense for scarce network capacity to be tied up for years by projects with little prospect of being built. But the proposed solution risks creating a different problem.

The centrepiece of Ofgem's proposal is a new Data Centre Commitment Fee (DCCF). This is essentially a large financial guarantee. The solution is simple and will certainly deter some speculative applications. But it risks rewarding the strongest balance sheets rather than the projects making the most useful progress. That may also push a diverse development ecosystem towards a smaller number of large or vertically integrated players, and, by reducing the range of mature sites available to hyperscalers, could ultimately reduce or delay investment in GB.

Following its consultation, Ofgem will hopefully undertake an impact assessment of the likely effects of the planned regime – including on developer behaviour, competition and the types of projects that come forward. That analysis will be important in determining whether the final package strikes the right balance between deterring speculation and preserving a diverse pipeline of credible projects.

Show me the money

Ofgem's proposed regime is, in some ways, relatively simple. At its heart is the DCCF. For projects of 40 MW or more, developers would need to provide financial security from the point they accept a Gate 2 connection offer until energisation. The proposed fee is large: £237,500 to £712,500 per MW. For a 500 MW development, that is roughly £120 million to £360 million of security.

That does not necessarily mean putting aside cash. Ofgem proposes allowing established forms of credit support. But developers still need the balance sheet, banking capacity or financial backing to stand behind a very substantial obligation.

The question is whether that is the right test of whether an early-stage data-centre project is serious.

It's about time

The grid and the customer operate on rather different clocks. A grid connection may take a number of years to secure, particularly where substantial network reinforcement is needed. But the ultimate hyperscale customer tends to operate on a much shorter horizon. Published evidence is inevitably imperfect because many commercial negotiations are private. But what is available points fairly consistently towards hyperscalers securing capacity materially closer

to delivery. CBRE, for example, has reported hyperscalers securing space around 24 to 36 months in advance.

That creates a timing problem.

Take a 500 MW project with a Gate 2 connection date seven years away (for example, as a result of the need for transmission substation development and/or deeper network upgrade works). Under Ofgem's proposal, the developer could need to provide £120 million to £360 million of security as soon as the connection offer is accepted. Yet at that point the project may still be several years away from the period in which the ultimate hyperscaler is prepared to make the commitment that supports the investment.

That exposure is more than a financing cost. The fee is returned if the project proceeds as planned, but can be forfeited if the project terminates or fails to comply with the relevant requirements. A developer accepting a connection years in advance is therefore taking a potentially very large exposure to planning, market demand and other delivery risks, some of which are only partly within its control. The fee also sits alongside the ordinary connection securities.

Some risk of forfeiture increases the impact of the fee and may therefore be relevant. The question is whether the risk implied in the proposals is proportionate, given the point in the development cycle at which it would be applied.

None of this is news to Ofgem. It actually recognises that anchor customers often emerge later in the development process. As a result, the proposed process foresees progressively stronger evidence of customer demand, culminating in binding evidence much closer to connection. But despite that, the proposals require very substantial financial security years before the customer commitment that would ordinarily help support it.

Does a deep pocket make a good project?

Ofgem's underlying logic is in some senses understandable. If a project is genuinely viable, the market ought to be prepared to provide the financial backing needed to stand behind it. Ofgem goes so far as to suggest that an inability to post the fee may indicate an inability to secure an offtaker, financing or investment, and therefore that the market considers the project insufficiently likely to deliver.

But project viability and early-stage financeability are not quite the same thing.

A data-centre site might be an excellent proposition for 2034. The land may be suitable¹, planning achievable, the network solution credible and eventual customer demand strong. None of that necessarily means that an independent developer can obtain hundreds of millions

¹ For a deeper dive on the suitability of different areas of GB for datacentres, see <https://www.frontier-economics.com/uk/en/news-and-insights/articles/article-i21755-power-pipes-and-people-mapping-england-s-ai-data-centre-puzzle/>

of pounds of credit support in 2027, before the ultimate customer is ready to sign. So the fee may ultimately test access to a large balance sheet. It also tests the developer's appetite to put that balance sheet at risk against uncertainties that may not be resolved for several years.

Does that matter? On Ofgem's own objectives, potentially quite a lot.

Ofgem is quite explicit that it does not want to reshape the market unnecessarily. Its stated objectives include imposing the lowest feasible financial and administrative cost burden on viable developers and, where possible, avoiding undue distortion of competition or restrictions on the diversity of data-centre types and business models.

Ofgem also recognises that the sector already contains a variety of specialised intermediaries. Its consultation identifies powered-land developers that secure land, planning and grid connections before packaging projects for other investors or developers, and energy and infrastructure developers that create integrated land and power propositions before partnering with a hyperscaler or colocation provider. Ofgem also notes that hyperscalers themselves may acquire projects or land from these businesses rather than originating everything in house.

Ofgem does expect its fee to affect what it calls “powered land banking”. It appears to expect these businesses either to take projects much further towards delivery themselves, or to transfer them earlier to better-capitalised developers able to carry the financial commitment through to energisation. The intention is clear enough: to discourage developers from cheaply accumulating grid positions in the hope that one subsequently becomes valuable.

It is undeniable that this sort of activity is creating an obvious problem today. But in contrast, a developer that spends meaningful money securing land, navigating the planning system, undertaking environmental work and developing a credible grid solution is doing something different and potentially useful. It is taking early-stage risk to create a proposition that an eventual hyperscaler can actually use.

A very large financial guarantee will certainly deter “powered land banking”. The concern is that it may also deter quite a lot of the productive development. And the consequence could be a market tilted towards very large, diversified developers, major colocation businesses and hyperscalers themselves.

This is hard to reconcile with Ofgem's stated desire not to distort competition or restrict viable business models. But there is a wider risk. Hyperscalers can certainly develop sites themselves, but there is no obvious reason to assume that vertical integration is the most efficient model. Specialist developers may have comparative advantages in land assembly, planning, environmental assessment, grid development and dealing with local stakeholders. If fewer of them are willing or able to originate GB sites, hyperscalers may ultimately have fewer mature, power-secured propositions from which to choose.

Given that data-centre capital is internationally mobile, the relevant downside is not simply fewer speculative GB applications. It is potentially fewer genuinely investable GB projects. It is not clear whether Ofgem has considered this risk.

And there may be a further push in this direction. Under Ofgem's proposed regime, even for well-capitalised developers, securing a grid connection would become more expensive. Pushing connection applications to later in the process is sub-optimal, as developers need to understand whether a particular site has a plausible connection solution. And if something costs more, you tend to get less of it.

All of this sits awkwardly with Ofgem's statutory Growth Duty, under which it must have regard to the desirability of promoting economic growth. A reform that deters speculative capacity but also reduces the supply of genuinely investable sites could cut across the growth outcome Ofgem should be trying to support.

Planning ahead

There may be a better way of distinguishing speculative projects from developments that have a credible pathway to delivery (a phrase which is borrowed from Ofgem's work on long-duration electricity storage, where Ofgem is thinking about a similar idea in a different context). Rather than requiring delivery risk to have disappeared at the outset, remaining risks can be managed through conditions and time-bound milestones as projects progress.

For data centres, the Gate 2 test does not need to prove that a project is ready to build. Rather, the focus should be on establishing that there is a sufficiently credible pathway from the project's current position to delivery.

Outline planning permission (perhaps combined with a smaller financial hurdle) could provide part of that evidence. It obviously does not prove that a project will go ahead, but could represent a productive and proportionate signal.

This is not a novel suggestion. In Ofgem's earlier Call for Input, planning attracted broad support as a Gate 2 readiness test, and outline planning was the more favoured approach. Respondents argued that obtaining it requires significant time and capital, provides meaningful evidence that a project is serious, but avoids prematurely fixing the detailed design. That flexibility matters because the eventual technical configuration may be shaped by the requirements of the customer, which may not yet be known.

Ofgem decided not to take outline planning forward as a formal Gate 2 requirement. Its concerns included differences between local planning authorities and the possibility that permissions could lapse where connection dates were a long way into the future.

Those concerns are worth testing. But neither necessarily means that outline planning is the wrong economic test. And Ofgem's proposed alternative is not without its costs either.

Local planning authorities operate within a common statutory framework, albeit with local plans and local discretion, and the difficulty of securing consent for a large site is part of why planning can be meaningful evidence of seriousness. Long-dated connection dates create a timing issue, but that can be managed through the timing of applications and requirements for subsequent planning progression.

The possibility that an early permission cannot simply be obtained and then left untouched for seven years may point towards a more sensible model. Outline planning could provide evidence of seriousness when Gate 2 is awarded. The developer could then be asked to show continued progress as the project matures, moving through reserved matters, refreshed or more detailed planning and increasingly firm commercial arrangements.

That need not mean networks only hear about a project once outline planning has been secured. The framework could preserve an earlier route for developers to signal credible prospective demand, so that reinforcement can be planned in time, while applying the higher readiness hurdle to the award or retention of firm Gate 2 rights.

Financial security could follow the same principle. It could be meaningful but relatively modest at Gate 2, then rise over time as the connection becomes more valuable, the project becomes more mature and the point at which a customer could reasonably be expected to commit approaches. This is not entirely alien to Ofgem's own thinking: its earlier Call for Input included an option under which a deposit would increase over time and become payable if projects failed progression criteria.

Belt, braces and a binding customer?

There is also a more basic question about how many filters are needed. The commitment fee would sit on top of existing connection securities and the proposed M1-M8 queue-management regime. More than one instrument can make sense: a fee can make a queue position costly to hold while milestones test continued development and delivery progress. The question is whether each additional test addresses a distinct residual risk. If the fee is intended to be the principal financial filter on speculation, Ofgem should think carefully about what residual problem each additional commercial test addresses.

The case for the additional customer and procurement milestones also depends on what the new entry requirements are expected to achieve. The current problem is that developers can secure valuable connection positions while having relatively little at risk and, in some cases, little realistic prospect of securing a customer. If Gate 2 instead required outline planning permission alongside a meaningful forfeitable financial commitment, the projects entering the firm queue would already have cleared a much higher hurdle. Ofgem would still need to ensure that they remain on a credible pathway to delivery. But it is less obvious why that should require the regulator to prescribe how and when developers procure equipment or contract with customers. Otherwise, there is a risk of solving the weaknesses of the old regime twice: first through much stronger entry requirements, and then again through detailed intervention in the commercial development of projects that have already demonstrated significant commitment. And with more regulation comes a higher risk of unintended consequences.

The important point is that the evidence of commitment could evolve with the project and address relevant risks. Early on, the test could be whether the development itself is credible and has a pathway to delivery, not just whether the developer has the balance sheet to underwrite risks that naturally remain at that stage. As the project matures, the tests could

focus on objective evidence that it is continuing to progress, alongside increasing financial commitment, reducing the risk that consumers are left funding assets that are not used.

That does not necessarily require Ofgem to prescribe the developer's customer-contracting strategy or particular route to market. And it seems a better fit with how the market develops projects than imposing the strongest financial test at the start.

Getting the timing right

Ofgem is right that data-centre developers should have to earn the right to reserve scarce network capacity. The difficult question is how. A large financial guarantee is simple and will certainly deter some speculative applications. But it risks rewarding the strongest balance sheets rather than the projects making the most useful progress. That may also push a diverse development ecosystem towards a smaller number of large or vertically integrated players, and, by reducing the range of mature sites available to hyperscalers, could ultimately reduce or delay investment in GB.

The electricity system and the data-centre market operate on different clocks. Networks need credible signals many years before connection. Hyperscalers often make binding commercial decisions much closer to delivery. A good connections regime needs to recognise that mismatch, preserve sufficiently early signals for network reinforcement, and allow projects to demonstrate a credible pathway from early development to committed delivery.

There is still more work to do to ensure that the cure does not screen out more than speculation. Ultimately, the choice between the different approaches to queue management should be based on a fuller impact assessment of their likely effects – including on developer behaviour, competition and the types of projects that come forward. That analysis will be important in determining whether Ofgem's final package strikes the right balance between deterring speculation and preserving a diverse pipeline of credible projects.

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