

All persons with an interest in
offshore electricity transmission

*Promoting choice and value for
all gas and electricity customers*

Our ref: 98/10
Direct Dial: 0207 901 7327
Email: colin.down@ofgem.gov.uk

Date: 29 July 2010

Dear Colleagues,

Consultation on the draft generic Offshore Transmission Owner Licence: Proposed new condition A3 (Market Rate Revenue Adjustment)

Background

We have been consulting extensively on the draft generic Offshore Transmission Owner Licence ('OFTO Licence') conditions¹ since March 2009 with a view to finalising a set of conditions for the grant of the first set of licences for offshore transmission assets tendered under Tender Round 1 ('TR1').

On 1 March 2010 we published version 0.5 of the generic OFTO Licence and project specific versions of this licence against which qualifying bidders were invited to submit their bids for the Invitation to Tender ('ITT') phase of TR1. We committed to undertake a housekeeping review of version 0.5 of the OFTO Licence to make any drafting improvements necessary in the lead up to licence grant. We have since received and evaluated ITT bids, and our decisions on preferred bidders in respect of TR1 projects are imminent.

This letter:

- sets out the process by which we intend to propose modifications to each OFTO Licence;
- sets out our proposal to incorporate a new licence condition A3 (Market Rate Revenue Adjustment) into each OFTO Licence to facilitate the licence grant process and simultaneous financial close and asset transfer;
- invites comments on a) the scope and drafting of the proposed new licence condition A3, and b) the necessary changes to other proposed licence conditions as a consequence of new licence condition A3; and
- sets out the next steps for the finalisation of the OFTO Licence in the lead up to licence grant.

The drafting of the licence conditions in the annex to this letter is generic and may need to be modified on a project specific basis.

Proposed licence modification process

The Authority has powers under the Electricity Act 1989 ('the Act') to grant and modify licences. Although it is possible to incorporate the OFTO specific provisions into the licence by using the licence modification mechanism provided for in section 11 of the Act, a major disadvantage of this approach is that the OFTO specific provisions cannot form part of the licence from the day of licence grant. This is because the earliest a statutory consultation under section 11 of the Act may commence is on the day of licence grant. We believe this

¹ See Annex 1 & Annex 11 at
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=24&refer=Networks/offtrans/pdc/cdr/cons2009>

approach would not suit a process involving simultaneous licence grant, financial close and asset transfer.

We now intend to make use of our powers under section 8A of the Act to propose a modification² to the standard conditions of each OFTO Licence in granting the licence in order to incorporate the OFTO specific provisions³ in the licence at the time of grant. We consider that this approach is transparent and necessary to provide certainty to each offshore transmission licensee and their funders from the day the licence is granted regarding their revenue entitlements, allowing them to achieve financial close. The section 8A process requires that the licence modification consultation be carried out and concluded ahead of licence grant and the OFTO specific provisions be incorporated into each licence on the day of licence grant. We consider that the 8A approach is better suited to the grant of an OFTO Licence where the revenue stream has been determined by a tender process and the revenue entitlement is required to be fixed on the day the licence is granted.

The above approach will not have a material impact on the content or intent of the OFTO specific provisions, nor will it have an impact on enforceability of the licence or on the revenue stream bid through the tender process. We have written to DECC setting out our intention to incorporate the OFTO specific provisions as amended standard conditions using powers under section 8A of the Act.

We previously followed the traditional approach of developing the OFTO specific licence conditions as "special conditions" using powers under section 11 of the Act. Under a section 8A modification, the OFTO specific provisions will be incorporated into each OFTO Licence as 'amended standard conditions'. We plan to do this by altering⁴ standard condition E12 which is currently titled "(Not Used)" and adding the OFTO specific provisions as amended standard conditions E12 - A1 to E12 - J10. The numbering of the amended standard conditions is intended to correspond to that of the special conditions.

Rationale for new licence condition A3

The proposed licence condition A2 (Post Tender Revenue Adjustment) in version 0.5 of the OFTO Licence⁵ provided a mechanism to adjust the revenue stream in specific circumstances once the licence has been granted. This included a provision for making a revenue adjustment to reflect the change in the debt market rates assumed prior to the transfer of the transmission system and those determined on the day that the transmission system is transferred. However, any modifications made in accordance with licence condition A2 would have been subject to a statutory consultation process under section 11 of the Act which can only commence after licence grant and may not provide the required certainty on the prospective licensee's revenue entitlement before the licence is granted. In response to these concerns we have separated out elements of licence condition A2 and made some refinements to form proposed new licence condition A3. One proposed refinement is to introduce the ability for the Authority to issue a direction so that the Authority can determine the value of the market rate adjustment (MRA_t), in accordance with the market rate adjustment methodology statement, on the day of licence grant and asset transfer to reflect the market rates on that day.

Version 0.5 of the OFTO Licence already reflected responses which highlighted the inadequacy of licence condition A2 (Post Tender Revenue Adjustment) to accommodate a range of funding solutions. Subsequent analysis of the ITT bids has identified further matters to be addressed associated with the process requirements and timings of financial close protocols and how these align with the processes set out in licence condition A2. To address this we have formed licence condition A3 (from licence condition A2 with some refinements) as a means of ensuring the revenue adjustment for market rates as part of

² "modifications" includes additions, alterations and omissions and cognate expressions shall be construed accordingly (section 111 of the Act).

³ These are currently set out in the [generic Special Conditions A1 to J10](#) and include incentive, capacity availability, regulatory reporting, revenue entitlement and other OFTO specific provisions.

⁴ Section 111(1) of the Act defines "modifications" to include "additions, alteration and omissions".

⁵ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=29&refer=Networks/offtrans/rott>

the financial close process in a way that is compatible with our expected statutory process for granting the OFTO Licence for a range of funding solutions.

The proposed drafting of this condition together with consequential drafting refinements to OFTO specific licence conditions A2 (Post Tender Revenue Adjustment) and J2 (Restriction of Transmission Revenue: revenue from transmission owner services) are provided in Annex 1 to this letter.

Proposed changes to other licence conditions

As a consequence of the proposed introduction of new licence condition A3, we have identified a number of necessary changes to licence conditions A2 and J2. In addition, the mechanics of the process to asset transfer and the development of the transaction structure for TR1 projects means that elements of these conditions may no longer be fit for purpose and therefore must be refined. Our proposed drafting refinements are reflected in Annex 1. The scope and rationale for the necessary refinements are:

- A2 – Deleted provisions that are now captured by A3.
- A2 - Amended scope of PTRAs to describe in more detail the possible adjustments that could result from the various TR1 transaction structures and introduced further clarity on the PTRAs process. For example, PTRAs now:
 - specifically addresses the permissible changes to base revenue resulting from the conclusion of Ofgem’s ex post assessment process. We propose that the permissible changes will relate to the assessment of the value of the assets, the timing of the completion of the ex post assessment and the consequential costs efficiently incurred by the licensee as a result of both scenarios.
 - clarifies that the Authority shall notify the licensee of its proposed determination of PTRAs as soon as reasonably practicable which is consistent with the existing provisions of paragraph 3 to make the determination as soon as reasonably practicable after asset transfer.
- J2 – Reverted to the definition of TRS_t contained in version 0.3 of the OFTO Licence so that the tender revenue stream can be finalised in accordance with the expected process to close.
- J2 – amended the process for determining the PR_t term so that the value can be directed by the Authority at asset transfer along with the MRA_t term. PR_t was initially drafted anticipating a section 11 consultation process whereby the value would be inserted into the licence after licence grant.

To the extent that there are circumstances where Ofgem’s ex post assessment is greater than the ex ante estimate, such that the licensee needs to secure further funding, Ofgem may consider modifying licence condition A2 on a licensee specific basis to incorporate the mechanics of such circumstances.

We believe these proposed changes relate only to process and do not affect the intent of licence condition A2 as proposed in version 0.5 of the OFTO Licence, and the proposed changes will not affect the level of the revenue entitlement.

Next steps

In relation to the changes set out above, we are running this two week consultation to enable us to issue the next version of the OFTO Licence to ensure that Preferred Bidders have the necessary version of the OFTO Licence to complete their due diligence once appointed.

Following the close of this consultation we will publish the next draft version of the generic OFTO Licence incorporating subsequent changes resulting from this consultation and any further refinements that our ongoing housekeeping review of the OFTO Licence has identified as necessary. This will include a review of the most appropriate structure and sequencing of the OFTO Licence in light of the addition of new licence condition E12 - A3.

Interested parties are invited to provide comments on:

- our proposed approach to enabling the revenue adjustment for changes in market rates;
- the detailed drafting of proposed new amended standard condition A3; and
- the proposed drafting refinements to amended standard condition A2 and J2 to accommodate the incorporation of new amended standard condition A3.

All consultation responses should be emailed to offshoretransmission@ofgem.gov.uk by no later than 5pm on **12 August 2010**. Anyone who wishes to raise queries should contact Colin Down (colin.down@ofgem.gov.uk or 0207 901 7327) or Laura Nell (laura.nell@ofgem.gov.uk or 020 7901 7147).

Yours faithfully

Stephanie McGregor
Director, Offshore Transmission

Annex 1 – Proposed Amended Standard Conditions E12 - A2, A3, and J2

Amended Standard Condition E12 - A2: Post Tender Revenue Adjustment

1. The purpose of this condition is to establish the process for adjusting (whether upwards or downwards) the base transmission revenue (BR_t) (as defined in amended standard condition E12 - J2 (Restriction of Transmission Revenue: revenue from transmission owner services)) that is required as a consequence of the difference between:
 - (a) the Authority's estimate of the costs associated with developing and constructing the transmission system to which this licence relates; and
 - (b) the Authority's assessment, once the transmission system is available for use for the transmission of electricity, of the costs associated with developing and constructing the transmission system to which this licence relates.
2. As soon as reasonably practicable after asset transfer, the Authority shall determine the value of the adjustment to base revenue, being the Post Tender Revenue Adjustment ($PTRA_t$) (as defined in amended standard condition E12 - J2 (Restriction of Transmission Revenue: revenue from transmission owner services)) used to adjust revenue for the difference defined in paragraph 1(a) and 1(b).
3. For the purposes of paragraph 2, the Authority's determination of ($PTRA_t$) shall account for:
 - (a) the difference between:
 - i. the Authority's estimate, on the day that this licence condition comes into force, of the costs associated with developing and constructing the transmission system to which this licence relates; and
 - ii. the Authority's assessment, of the costs associated with developing and constructing the transmission system to which this licence relates.
 - (b) the economic and efficient costs incurred by the licensee as a consequence of a change in the value of the transmission system as determined by the Authority in accordance with paragraph 3(a)(ii) above; and
 - (c) the economic and efficient costs incurred by the licensee as a consequence of the Authority's assessment in accordance with paragraph 3(a)(ii) being made at a time other than [six] months after its assessment in accordance with 3(a)(i).
4. In determining the appropriate adjustment:
 - (a) The Authority may request that the licensee provide such information that it reasonably requires for the purposes of making its determination. The Licensee is required to provide such information within the timescales set out by the Authority, being not less than 7 days from the date of any request;
 - (b) the Authority shall, as soon as reasonably practicable, notify the licensee in writing of its proposed determination of the adjustment to allowed transmission owner revenue ($PTRA_t$). Such notification shall specify the period within which the licensee may make representations in respect of the Authority's proposed determination, being not less than 14 days from the date of issue;
 - (c) the Authority, having regard to any representations made by the licensee and not withdrawn, may propose a modification to the $PTRA_t$ value set out in amended standard condition E12 - J2 (Restriction of Transmission Revenue: revenue from transmission owner services) pursuant to section 11 of the Act, and the proposed modification shall only take effect where made by the Authority;

- (i) in accordance with section 11 of the Act with the consent of the licensee; or
 - (ii) in the form originally proposed by the Authority following a reference to the Competition Commission under section 12 of the Act on the proposed modification of the condition; or
 - (iii) in such modified form as the Competition Commission may specify following a reference under section 12 of the Act on the proposed modification of the condition.
5. Nothing in this condition prevents the Authority requesting any further information that it considers necessary to make its determination in accordance with paragraph 2.

Amended Standard Condition E12 - A3: Market Rate Revenue Adjustment

1. The purpose of this condition is to establish the process for adjusting (whether upwards or downwards) the base transmission revenue (BR_t) (as defined in amended standard condition E12 - J2 (Restriction of Transmission Revenue: revenue from transmission owner services)) of the licensee for the difference between:
 - (a) market rates assumed in the tender revenue stream (TRSt) (as defined in amended standard condition E12 - J2 (Restriction of Transmission Revenue: revenue from transmission owner services)); and
 - (b) market rates determined on the date of asset transfer.
2. The licensee shall use reasonable endeavours to have in place on the date this condition comes into force, an Authority approved market rate adjustment methodology statement as is necessary to facilitate the achievement of the objectives defined in paragraph 3.
3. For the purpose of paragraph 2 of this condition, the licensee shall ensure that the market rate methodology statement facilitates the following objectives:
 - (a) that compliance with the methodology ensures that the market rate revenue adjustment (MRAt) shall only reflect changes in market rates;
 - (b) that compliance with the methodology ensures that the market rate revenue adjustment (MRAt) shall take account of the difference between market rates described in paragraph 1(a) and paragraph 1(b); and
 - (c) that compliance with the methodology ensures that the market rate revenue adjustment (MRAt) can be effected in a manner which is compatible with the financial close protocol.
4. For the purposes of paragraph 1, the market rate revenue adjustment (MRAt) shall be calculated in accordance with the Authority approved market rate adjustment methodology statement.
5. On the date of asset transfer the Authority shall direct in writing the value of the market rate revenue adjustment (MRAt), calculated pursuant to paragraph 4, by way of a Direction.
6. In this condition:

“asset transfer”

means the transfer to the licensee of transmission assets to which this licence relates as set out in Annex B to amended standard condition E12 - B1 (transmission system area).

“financial close protocol”

means the process and/or timescales agreed with the Authority to effect the funding for asset transfer.

“market rates”

means the following:

- (a) interest swap rates; and
- (b) retail price index swap rates.

Amended Standard Condition E12 - J2: Restriction of Transmission Revenue: revenue from transmission owner services

- 1 The purpose of this condition is to establish the revenue restriction that determines the allowed transmission owner revenue that the licensee may earn from its transmission owner services in any relevant year.
- 2 The revenue entitlement of the licensee, determined in accordance with paragraph 3 below, shall commence upon the date this condition comes into force.

Part A: Transmission Owner Revenue Restriction

- 3 The licensee shall take all appropriate steps within its power to ensure that in any relevant year t , regulated transmission revenue shall not exceed the allowed transmission owner revenue calculated in accordance with the formula given in paragraph 4 below.

Formula for Allowed Transmission Owner Revenue (OFTO_t)

- 4 For the purposes of this condition, allowed transmission owner revenue (OFTO_t) shall take the value of zero all relevant years preceding the commencement relevant year t and thereafter allowed transmission owner revenue (OFTO_t) shall be calculated in accordance with the following formula:

$$OFTO_t = BR_t + PT_t + PA_t - K_t \quad (1)$$

where:

OFTO_t means allowed transmission owner revenue in the relevant year t .

BR_t means base transmission revenue which shall be calculated as:

$$BR_t = (TRS_t + MRA_t + PTR A_t) \times PR_t \times RIT_t \quad (2)$$

where:

TRSt means the tender revenue stream and shall take the value of [£xxx], in tender relevant year prices;

MRA_t means the market rate revenue adjustment and shall take the value in the Authority's Direction pursuant to amended standard condition E12 - A3 (Market Rate Revenue Adjustment), otherwise it shall take the value zero;

PTRA_t means the post tender revenue adjustment and shall take the value in the Authority's determination pursuant to amended standard condition E12 - A2 (Post Tender Revenue Adjustment), otherwise it shall take the value zero;

PR_t means the proportion of revenue term representing the proportion of the tender revenue stream to be recoverable in that relevant year and shall take the value 1, except:

- (a) in respect of the commencement relevant year where it shall take the value indicated in the Authority's Proportion of Revenue Direction;
- (b) in respect of the closing relevant year where it shall take the value indicated in the Authority's Proportion of Revenue Direction; and
- (c) in all relevant years subsequent to the closing relevant year, where it shall take the value zero.

RIT_t is the revenue indexation adjustment term for the relevant year t, and shall be derived from the following formula:

$$RIT_t = (1 + RPI_t) \times RIT_{t-1} \quad (3)$$

where:

RPI_t means the percentage change (whether of a positive or a negative value), expressed as a decimal number, in the arithmetic average of the Retail Price Index numbers published or determined with respect to each of the twelve months from January to December (both inclusive) in relevant year t-2 and the arithmetic average of the Retail Price Index numbers published or determined with respect to the same months in relevant year t-1; except in:

In the tender relevant year, RIT_{t-1} shall take the value 1.

PT_t means the pass through revenue adjustment term, whether of a positive or of a negative value, made in the relevant year t in respect of allowed pass through items as derived in accordance with amended standard condition E12 - J3 (Restriction of Transmission Revenue: Allowed pass-through items);

PA_t means the performance availability revenue adjustment term, whether of a positive or of a negative value, made in the relevant year t in respect of annual revenue adjustments as derived in accordance with amended standard condition E12 - J4 (Restriction of Transmission Revenue: Annual revenue adjustments);

K_t means the revenue restriction correction factor, which is the difference between the regulated transmission revenue (AR_{t-1}) and the allowed transmission revenue ($OFTO_{t-1}$) in the previous year, whether of a positive or of a negative value, which is calculated in accordance with the formula below:

$$K_t = (AR_{t-1} - OFTO_{t-1}) \times \left[1 + \frac{(I_t + PI_t)}{100} \right] \quad (4)$$

where:

AR_{t-1} means the regulated transmission revenue in respect of the relevant year t-1.

$OFTO_{t-1}$ means the allowed transmission owner revenue in the relevant year t-1.

I_t means the average specified rate (as defined under those words in amended standard condition E12 - J1 (Restriction of Transmission Revenue: Definitions)) in the relevant year t.

PI_t means the penalty interest rate in relevant year t, which is equal to:

(a) where

$$AR_{t-1} > 1.04 \times OFTO_{t-1}$$

the penalty interest rate shall be 4 per cent; and otherwise, it shall take the value zero.