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Our Reference NG/LAD

Dear Robert,

Offshore Electricity Transmission – A Joint Ofgem/BERR Regulatory Policy Update

This response is from National Grid in respect of our interest in becoming an OFTO and thus a potential investor in offshore transmission networks. It has been prepared by a National Grid business development team who are separate from National Grid Electricity Transmission activities relating to offshore transmission (i.e. both GBSO and onshore TO).[1]

Our responses to the consultation questions are as follows:

Q2.1. Should the regulated revenue stream be adjusted and, if so, how should this be designed?

Given that there are powers under the Electricity Act to modify OFTO licences, and OFTO licensees will be required to meet obligations set out in various codes that are also subject to modification, OFTOs face the risk that new obligations could be introduced that would imply significant additional and un-remunerated costs during the 20 year fixed revenue period. While the high level duties of the Authority give some comfort that modifications will only be approved when appropriate, there may be circumstances when modifications that are in the consumer's interest could be detrimental to OFTOs unless a compensating adjustment is made. For this reason, an 'unknown unknowns' re-opener should be formalised in the OFTO licence such that a revenue stream adjustment is considered when the incremental cost associated with a regulatory decision exceeds a predetermined threshold.

Concerning 'known unknowns' like insurance and other operating costs, we suggest that indexing revenues by RPI would be appropriate because users and consumers will be generally better placed to manage inflation risk than an OFTO with predetermined revenues. As these operating costs could be significantly affected due to wider regulatory or legislative changes (e.g. concerning health and

[1] This response has been prepared in accordance with National Grid's code of conduct concerning NGET and offshore transmission owner interests including the associated information ring-fence.

safety, the environment, taxation or other financial obligations), the 'unknown unknowns' adjustment mechanism should also address these areas when a sufficiently material change occurs.

Q2.2.What are your views on the updated policy position on incremental capacity?

We agree that a requirement to tender firm prices for increments of up to 20% of the specified capacity should be feasible and should not unduly increase tender reply costs.

From an OFTO perspective, a firm capacity obligation determined at the outset of the construction phase means that designs can be frozen and delivery optimised to a greater degree than if the option to call the 20% increment remains open for longer.

For incremental capacity required post-construction, we agree that increments requiring significant new investment (such as construction of a new circuit) should be the subject of a new tender for the new works. For other incremental capacity (not requiring major new construction) we think the OFTO should be able to bid a price, and for the avoidance of doubt, such prices would not be constrained to reflect the original pre-construction 20% increment bid prices.

Q2.3.What are the appropriate structure and level of OFTO performance incentives?

We question the proposal not to have an operational loss incentive because it exposes consumers and offshore generators to the potential for selected low loss designs not being delivered in practice (for example, by avoiding the cost of more expensive materials when seeking to deliver the scheme to budget). While we accept there are difficulties in developing an operational loss incentive scheme given the variability of the cable utilisation, other approaches can be used to ensure delivered network performance matches design. For example it would be possible to measure the resistance of installed AC links. It would also be possible to derive the equivalent resistance of both AC and DC systems by monitoring annual loss, average loading and the associated annual loss load factor.

We agree with the proposal that there should be a delivery incentive to penalise delayed provision of network assets and we agree that normal construction practice regarding liquidated damages (a percentage of charges per week up to maximum penalty) would be suitable.

Given that offshore generators will highly value available network capacity (because their energy and ROC revenues are conditional on delivery of their electricity) we agree that OFTOs should have aligned incentives on this aspect. Provided the requirements are clear at the tender invitation stage, OFTOs will be able to adopt appropriate arrangements (including capital structures, insurance, repair call-off arrangements, etc) and price these into their bids. Ofgem will need to ensure that the incentives do not excessively value reliability because this would give rise to costs in excess of any benefits arising from the actions that could be taken by OFTOs under the incentives. Ofgem will also need to ensure that OFTOs are sufficiently financially robust to withstand external events (for example, damage by third parties) without financial distress or liquidation. We suggest appropriate exposures could exceed 2% of annual revenues but agree that more than 10% would be excessive.

Q2.4. What should be the role of the generator in defining performance incentives?

Generators will be best placed to describe the performance aspects they most value. However, to make informed choices, generators will need information about the cost consequences of seeking different levels of performance at the requirement setting stage. Given the expense and difficulty of evaluating different sets of performance requirements through the tender process, we suspect that generators may want to adopt a generic performance package in most cases (for example, performance incentives consistent with the availability assumptions underpinning the offshore security and quality of supply standard) unless they have themselves already made detailed design investigations.

Q2.5. What actions should be undertaken in the event of persistent OFTO underperformance?

If effective performance incentives are established, then consistent poor performance by an OFTO should result in poor returns. Additional post-event regulatory intervention, for example instigating licence termination, would increase regulatory risk and reduce the scope for potential OFTOs to formulate business solutions.

Q3.1. Preconditions for the tender process

We agree with the proposed preconditions for transitional schemes subject to the final precondition also including an independent engineering audit report on the design of works that have not been completed by Go-Active (in addition to such a report on the functioning and performance of completed works). We suggest that such reports, together with any engineering reports commissioned by Ofgem in their valuation of transitional schemes, should be included in the data room as they become available.

The proposed project preconditions under the enduring scheme (for Crown Estate leases as well as a bilateral agreement with NGET) are pragmatic and should reduce the risk of unwanted access hoarding.

Q3.2. Treatment of seabed surveys

We agree that it is appropriate for Ofgem to retain flexibility in this matter such that the suitability and feasibility of bidders conducting a joint seabed survey can be considered on each project.

Q3.3. Linkages between tender and connection processes

The use of tender windows should assist the co-ordination of connection designs and the flexibility to change their timing provides a pragmatic approach to project timing and tender volume uncertainties.

More generally concerning process timing issues, we understand that the requirements of the European Utilities Procurement Directive (2004/17/EC) are pertinent to the selection of equipment suppliers by potential OFTOs because a successful bidder, once licensed, will be carrying out a relevant utility activity. On this basis, the tender process should be arranged such that bidding OFTOs can address these requirements as necessary. In particular, allowing sufficient time to conduct the requirements of this directive will be critical.

Q3.4. OFTO construction security

We agree that such securities are desirable to ensure planned connection works for an offshore generation developer can be completed should the licensed OFTO be unable or unwilling to do so. While in theory the awarded revenue stream should be sufficient to fund the required works, if an OFTO is unwilling or unable to complete the works then there may be considerable uncertainty, particularly in the short-term, concerning whether such revenues will be forthcoming. For this reason, we do not see any advantage (with respect to the objective of ensuring the connections can be completed) of making securities smaller than 100% of the remaining work.

However, we do not understand the reason for proposing that NGET administrates the call-down of such securities under the STC rather than the party who becomes responsible for continuing and completing the works. It would be helpful if Ofgem could identify the process that they envisage would transpire should an appointed OFTO be unable or unwilling to complete the construction works. (For example, explaining how such arrangements would interact with the use of powers to appoint a special administrator under the Energy Act.)

Q3.5. Use of STC process for construction offers

We are not aware of the alternatives to this proposal and so are unable to assess whether there are any benefits or disadvantages of an alternative approach. As the GBSO is the party receiving transmission services from the OFTO, and the arrangements for managing the provision of these services are set out in the STC, it is logical that the construction offer process is also managed under this code.

We suggest that not only is it necessary for Ofgem to receive the information needed to establish a connection from the GBSO before conducting the OFTO appointment competition but also necessary for them to have a mechanism to ensure the GBSO contracts for the winning design from the successful OFTO. The draft licence condition E17 contains insufficient detail to discharge this requirement.

Q5.1. Does the licence drafting reflect policy positions?

We agree with the choice of existing onshore standard licence conditions that have been selected and transferred to the draft OFTO licence. As there is little OFTO specific text provided for the draft standard licence conditions and there are no sample special conditions available, it is not possible to comment on this question at this stage.

Q5.2. Are there any other issues that should be addressed through licence changes?

We note the reference in paragraph 5.19 of the policy update of the potential for OFTO companies to be established as subsidiaries of NGET and the potential for unwanted information exchanges that could then result. National Grid's bids to become an OFTO will continue to be prepared by a subsidiary of National Grid plc separate from NGET and in accordance with a code of conduct established and shared with Ofgem. In accordance with this code, if a National Grid OFTO bid is successful, then any established OFTO company could not be a subsidiary of NGET. To clarify and eliminate any suspicion that a loophole might be exploited, National Grid would accept a licence prohibition on establishing OFTO subsidiaries to NGET.

Q6. Does code drafting reflect policy positions?

We have not identified any gaps between drafting and policy.

I hope these comments are helpful in finalising the proposals for the offshore transmission regulatory regime.

Yours sincerely,

Lewis Dale

Cc:
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