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**SENT BY E-MAIL**

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Dear Megan,

**Offshore Electricity Transmission: Consultation on licence policy for future tenders (159/12)**

This response from National Grid Offshore is provided from the perspective of an experienced bidder in the transitional OFTO regime.

A key feature of this consultation is that it highlights the limitations of OFTO availability incentives on already designed and built offshore transmission systems for the benefit of consumers. The changes proposed to the OFTO availability incentive provide refinement, but they do not materially influence the overall performance and costs of designed and built transmission systems. Indeed, from our preliminary quantitative assessment of the proposed  $ax^b$  weighting mechanism there may be unintended consequences of additional costs for consumers where bidders factor increased revenue risks due to this capacity weighting into their TRS bids.

With the continuation of the Generator Build model, and without an OFTO Build model being supported by generators, decisions related to appropriate transmission design and value for money for consumers fall to Ofgem's cost assessment process. We think that this should be a priority area of consultation relevant to policy for future OFTO tenders.

Yours sincerely,

**Morris Bray**

Q2.1 Do you agree that the 20 year revenue stream is still appropriate for point to point systems?

A2.1 We agree that the 20 year revenue stream is still appropriate. In line with our response to a similar question in Ofgem's consultation of 16<sup>th</sup> December 2011, we are open to consideration of project-specific OFTO licence periods, ideally consistent with wind farm generation licence periods (e.g. 35 years or longer). Longer revenue periods would allow beneficial amortisation of transmission costs, but at a potential cost of increased uncertainty in pricing as assets may require additional investment in later years and also the risk of unnecessary cost to consumers if there is no life extension of the wind generation assets.

Regardless of the length of the licence period, clarity of what is expected to happen after the end of the licence is an important issue. The relative benefits of three approaches proposed (i) decommissioning, (ii) extending the existing licence and (iii) new tender process need to continue to be considered in more detail.

Q3.1 What do you think are the advantages and disadvantages of each refinancing policy option? Please explain why.

A3.2 The regime is attractive to investors because it offers a long term revenue stream and provides light touch on-going regulation that does not dissuade commercial business activity. The nature of the competitive process incentivises innovative bidding strategies in order to be successful. However, we consider that experiences of financing for these bids are still very limited and unproven. The potential for refinancing for OFTO is understandable because of the 20 year revenue period and the potential for market changes in this period. However, there may be other options to adjust cost of capital that allows the necessary symmetry and predictability for both bidders and consumers .

Q3.2 Are there other refinancing policy options that you think we should also consider?

A3.2 We recognise Ernst & Young's recommendations to Ofgem and recent report HC 621 from the Committee of Public Affairs. As a result, we refer to our response to a similar question in Ofgem's consultation of 16<sup>th</sup> December 2011. If Ofgem decides that refinancing gain sharing arrangements are appropriate for project finance (PF) structures, then it may also be appropriate to make use of corresponding adjustment mechanisms for non-PF bids. This could be done using some of the mechanisms in the onshore RIIO frameworks.

Q3.3 What are the benefits of OFTOs coming under common ownership and what are the associated issues that Ofgem should consider? To what extent should we capture any gains from OFTOs coming under common ownership?

A3.3 Any benefits of common ownership through a secondary market for OFTO will exist to the purchaser and vendor, whereas the benefits of common ownership by design of the primary market can be provided to the consumer, even though the quantum of benefit may be the same. Common ownership of adjacent or proximate OFTOs, will benefit from efficiencies of scale in operations and maintenance work planning, logistics, spares and co-location of premises. By having a single bid process covering more than one point to point connection, these efficiencies can be anticipated and factored into the TRS for the benefit of consumers. For bid processes covering single point to point connections, the same efficiencies of scale could also be realised by the purchaser in a secondary market. Ofgem has previously consulted on phases of a project being captured in the same tender, and we think this approach should capture efficiencies for consumers. However, where secondary markets do develop in OFTO ownership leading to generation of business efficiencies we would not expect further regulatory intervention at that stage.

Q4.1 What do you think are the advantages and disadvantages of each indexation policy option? Please explain why.

A4.1 In our response to a similar question in Ofgem's consultation of 16<sup>th</sup> December 2011 we noted that the principle of long term indexation of revenues is an important determinant and differentiator for investment in OFTO. However, there may be more benefits for consumers from a more focused approach e.g. only allowing indexation on bidder costs that are genuinely exposed to inflation rather than the whole TRS. The most obvious and significant proportion of the TRS is the transfer value,

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which is not exposed to inflation. An alternative would be to take this element out of RPI indexation. It should also be possible for bidders to differentiate in their approach to inflation risk. We continue to believe that the index-linked nature of OFTO investment is a positive differentiator and attractor for investors. We think that option 2, to allow biddable indexation, offers the greatest opportunity - both for Ofgem to competitively reduce TRS and for bidders to choose how they structure their bids. It provides flexibility for better alignment to bidder characteristics and it does introduce further scope for differentiation in bidding to the advantage of consumers.

Q4.2 Are there other indexation policy options that you think we should also consider?

A4.2 We consider that only options 1 or 2 will continue to provide the appropriate attraction for investors, subject to indexation of costs genuinely exposed to inflation rather than the whole TRS. The volatility of the insurance market is also a concern for bidders. Indexation alone on this element could expose bidders to unreasonable risks in the future.

Q5.1 Do you agree with our proposal to introduce the capacity weighting mechanism to the availability incentive mechanism?

A5.1 We consider that there is not enough evidence, experience or good analysis available to warrant a change to the existing incentive mechanism at this time. There are two issues associated with this position:

The first is that the capacity weighting mechanism is intended to provide sharper incentives for OFTOs. The question is whether the changes proposed by Ofgem do actually materially affect OFTO behaviour for the benefit of consumers. From preliminary analysis we have carried out of the weighting mechanism, the behaviour that will change is the extent to which bidders factor in out-performance in their TRS. TRS bids may actually increase with the capacity weighting incentive given that unforeseen unavailability (e.g. caused by faults) will cause OFTO revenues to hit their floor sooner. A capacity weighted incentive would drive quicker reductions in revenue but, given the 10% revenue floor, would not create any further incentive for quicker return to service because the cost of "readiness to repair quicker" outweighs the loss in revenues. As a result, the introduction of a capacity weighted incentive is likely to penalise the OFTO quicker, lead to higher TRS to compensate, but not providing enhanced incentive to return a faulted system to service quicker – which is not a benefit to consumers. The existing arrangements do already adequately incentivise response to these events, subject to the revenue floor.

The second issue is that for offshore transmission designed and built by generators, the availability of the built OFTO system is not a factor that bidders can materially influence. The main driver of unavailability of offshore transmission systems is the time to repair faults. OFTO design, installation and repair incentives aimed at reducing the incidence and duration of unavailable capacity due to such significant unplanned or unforeseen events is what will change behaviour. This can be better achieved through an OFTO Build model. However, with the continuation of the Generator Build model, Ofgem's cost assessment process becomes most important in determining outcomes.

In all, we can see potential for a negative effect on the UK consumer overall and we feel that a better approach would be to maintain the existing weightings based on agreed seasonal loadings and continue the requirement to have co-ordinated outage planning and review between the OFTO and the generator.

Q5.2 Do you agree with our proposal not to introduce a penalty differential between planned and unplanned outages to the availability incentive mechanism at this time?

A5.2 We consider that the issue here is not whether the outage is planned or unplanned, it is the time to return to service based on the nature of the outage that is the issue. The cost of reducing repair times on a planned basis would introduce significant costs for consumers in TRS bids, and will not be materially affected by an unplanned penalty differential.

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Q5.3 Are there any further issues that you feel we should consider as part of our enhancements to the availability incentive? If so, why?

A5.3 Provided in response to Q5.1. So long as offshore transmission is designed and built by generators to meet their performance requirements more emphasis will need to be placed on Ofgem's cost assessment process to determine whether the expected lifetime costs of offshore transmission designs provide value for money for consumers.

Q5.4 Going forward do you think that the use of TEC for the maximum availability will remain appropriate? If not, what project designs might TEC not be appropriate for and what alternative would there be?

A5.4 Although TEC is a variable it is a contracted availability and strong indication of the maximum generation expected. We think this is still an effective maximum availability for OFTO when coupled with the availability target.

Q5.5 Do you agree with our intention to remove the ICUA term and only use the ACA cost assessment term to calculate the remuneration required for providing additional capacity?

A5.5 It should be noted that there may be incremental capacity already achievable at no cost as a consequence of a bidder's evaluation of availability performance in the TRS i.e. redundancy may already have been factored into a bidders assumptions of availability performance. As such, the ACA cost assessment may need to lead to re-assessment of the overall bid. We recommend that the ICUA is still appropriate where rated capacity is higher than TEC and ACA is only appropriate where the availability exceeds rated capacity.

Q5.6 Do you agree with our intention to not introduce greater flexibility in relation to remuneration for incremental capacity at this time?

A5.6 We have previously suggested that the incremental capacity mechanism could be tailored to the circumstances of the tender. This is especially relevant where future phases of generation & transmission could be anticipated to be built in close relationship to the tender. We would support the assessment of funding for future offshore transmission investment for phases of a wind farm being carried out at the time of the tender for the initial phase. This places a value on firmness of cost of future funding for consumers and we would advocate more opportunity for bidders to differentiate in this way – whether the incremental capacity mechanism is a tender-specific proportion of the transfer value, a bidder-declared threshold value, or indeed a basis for a variant bid.

Q5.7 Do you believe that adding an absolute threshold for incremental capacity would be beneficial? If so, what should the value of the threshold be?

Q5.8 What are the benefits, drawbacks, risks and considerations in adapting the incremental capacity mechanism to allow Generator build of subsequent phases?

A5.7 & A5.8 Provided in response to Q5.6

Q6.1 What further areas relating to your planned or potential future projects do you think that Ofgem should consider in order to help facilitate the efficient delivery of the OFTO build model?

A6.1 We remain advocates of the OFTO Build model to determine appropriate design and cost of offshore transmission. While Generator Build continues, we have outlined in this consultation response the importance of Ofgem's cost assessment process in determining the appropriate design and cost of offshore transmission for consumers.

Q6.2 Do you have any comments on the relevance of changes to the RIIO licence on the OFTO licence?

A6.2 We have no comments