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National Grid Electricity System Operator (ESO) response to the Ofgem Offshore Transmission Owner (OFTO) End of Tender Revenue Stream Consultation concerning policy development

Dear Stephen,

We welcome the opportunity to respond to your OFTO End of Tender Revenue Stream Consultation.

The ESO holds a unique position at the heart of the nation's energy system. We use our unique perspective and independent position to facilitate market-based solutions which deliver value for consumers.

We have provided views in response to Section 3.1, 3.2, 3.3.1 and 3.3.2. We have not provided views in response to Section 3.3.3 as we do not have information and views to share on insurance in the context of those questions.

We imagine that further policy detail will become available as you continue to develop and consult upon your policy thinking on this topic in future. In most cases it is too early to express firm preferences so we have instead highlighted potential areas that you may wish to further consider in future, albeit we expect that many of the points we raise will already be under consideration.

It is also important that the Offshore Transmission Network Review remains mindful of this policy development work and vice versa. This will ensure that these arrangements can be future proofed as far as is practicable. In any event once further information on the future arrangements for offshore co-ordination is available it would be prudent to consider that information in the context of this policy development work to identify any potential future interactions. There may also be relevant considerations for the development of onshore competition.

If you require further information on any of the points raised in this response please let me know and I am happy to schedule some time for a discussion if that would be beneficial in future.

Yours sincerely,

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Section 3.1: Establishing whether extending offshore transmission system regulatory revenue periods is in the best interest of electricity customers.

Q1 - should asset health reviews be carried out on generator assets no later than five years before the end of the revenue stream, with the health review for the offshore transmission assets following shortly after that? If no, please set out alternative timelines and reasoning.

We think that generators and OFTOs are likely better placed to provide advice on this question, but an intuitive view is that this is reasonable.

Q2 - should generation and transmission health reviews be carried out by the generators, but informed and agreed by OFTOs and Ofgem, given that generation is likely to be the main driver for any extension? If not, please provide reasons.

We agree that this is a potentially viable option for further consideration. However, further consideration should also be given to the OFTO undertaking the transmission asset health review as they are the asset owners.

As such, the OFTO should have a better understanding of the health of their assets, including in relation to what is required to maintain the required level of availability for the extended life of the offshore wind farm assets. There could be some generator and Ofgem engagement within (and oversight of) the process for this alternative option and this could potentially also include a level of assurance for the process and outcome.

If the OFTO did undertake the asset health review for their own transmission assets we believe this should still be triggered by the generator and it should be shortly after the generator asset health review as per Q1 above.

Q3 - should generators pay for their own health reviews and those of the associated transmission assets? Please provide reasons for your response.

We agree that generators should pay for their own asset health reviews. However, the costs associated with the health review for the transmission assets requires further consideration.

Prior to a connection, generators pay for any optional feasibility studies and mandatory connection applications. Once connected and if required, they would also pay OFTOs (via the ESO) to assess any material changes to their connection e.g. via the modification application process. As an OFTO will likely need to spend additional money to facilitate the connection beyond the original revenue term, the generator paying for the transmission asset health review costs seems like a potentially viable option for further consideration i.e. those exploratory works could arguably be comparable to a feasibility study assessment as above.

However, this question could also be considered from another angle more favourable to offshore generators. More specifically, it could be argued that as the generator already has a connection to the transmission system they should not become liable for the direct costs associated with facilitating the OFTO extended revenue period. This would arguably be comparable with onshore generators and most types of onshore transmission assets.

We think this point will be important when considering some of the other questions and resulting processes i.e. to what extent is a generator liable for additional costs and risks associated with an extended revenue period. We are happy to explore this further with Ofgem and other relevant stakeholders as the policy thinking develops.

Q4 - what sort of confirmation/guarantee/representation of the intention to extend would developers envisage giving? What would this be subject to?

A connection agreement generally gives a generator connection rights in perpetuity until they provide notice to reduce capacity or disconnect from the transmission system. If, however, there are material generator-driven changes to the connection then a modification application would be required. If a modification application triggers additional works on the transmission system, the generator would need to contract for and secure the additional works. As such, depending on the timing in relation to the two asset health reviews and the subsequent revenue period extension process, this could potentially provide some level of consumer protection.

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However, if the extent of the change required to the wind farm (as a result of the generator asset health review) means there is no 'material change' then there may not be a requirement for a modification application process. In addition, if the transmission asset health review is the equivalent of a feasibility study then the transmission asset health review may not align with the usual modification process timescales. Therefore, whilst any OFTO maintenance or reinforcement works (not already funded by existing revenue) could eventually be secured via the modification application process, a separate process is likely also required if there is an intention to gain formal commitment from the generator in advance and throughout in respect of the extended revenue period.

As is considered in Q3 above, this all assumes the additional costs are viewed to be 'generator-driven' changes. An alternative view would be that these changes are not generator-driven and as such there should not be an impact on their connection arrangements, nor a need to provide any security for the additional expenditure. However, even if the generator were not to secure additional spend associated with an extended revenue period we agree that some form of commitment to proceed with the extension period warrants further consideration.

Section 3.1.1: Further Investment

Q5 - should the incumbent OFTO or the generator be responsible for any further investment required to enable an extension of the regulatory revenue period?

If the existing principles and arrangements for infrastructure are extended, then the OFTO should be responsible for additional investment on their assets to service the ongoing network requirements, subject to competition i.e. the continued connection of the offshore wind farm to the transmission system. As above, the extent to which the generator then commits to and secures any additional investment requires further consideration.

Therefore, any additional investment (whether it occurs prior to or within the extended revenue period) should be covered by the regulatory arrangements for the extended revenue period rather than as part of the existing revenue period. This appears to make the distinction between the existing revenue period and the extended revenue period clearer than if new investment for the extended revenue period were partially incorporated into the existing revenue period arrangements. However, this assumes the new revenue period arrangements are clarified early enough to give the OFTO enough certainty to invest early enough to facilitate the extension e.g. so they understand the return on investment and risks associated with that investment.

As noted, it is important that when setting the new allowed revenue (depending on how the process is defined) there is no allowance for investment which is already expected to be funded within the existing revenue period e.g. in relation to maintenance costs that would have otherwise been incurred in the existing revenue period.

The costs of any additional investment would then be covered by the generator via the charging regime i.e. via their local circuit and/or local substation tariffs within TNUoS. We will therefore need to further consider the mechanics of an extended revenue period within network charging arrangements as policy thinking develops.

Section 3.2: Extension options

Q6 - should the tender revenue period be extended with the incumbent OFTO, or licences retendered through open competition?

We believe that both options should continue to be explored and further information is likely required to make an informed decision. Competition could potentially result in a better outcome for consumers than if an extended revenue period were to be agreed bilaterally between an incumbent OFTO and Ofgem. However, there are also risks with this approach, especially where the extended allowed revenue is relatively low i.e. there will be complexity and risk associated with an asset transfer between the incumbent OFTO and the new OFTO for the extension period and these costs/risks could potentially erode the expected benefits of the competition.

If bilaterally setting an extended revenue period with the incumbent OFTO, Ofgem can ensure that consumers are adequately protected by setting suitable arrangements, as they do today where competition does not exist e.g. an appropriate return on investment and/or some form of gain sharing mechanism.

Therefore, whilst competition should be the aim if it is expected to deliver benefits to consumers, an extension with the incumbent OFTO could potentially be a more appropriate option in some circumstances.

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Q7 - do you consider that there is a threshold to be met to determine which approach to be taken (if there is to be any further regulatory revenue period at all)? For example, the extension period is above a certain number of years, or the tender revenue stream is above a certain value?

We agree, although further work is required to determine an appropriate threshold. There is a possibility that the threshold can be set on a case-by-case basis rather than being a fixed threshold e.g. the implementation of a form of cost-benefit analysis to demonstrate that consumers are expected to benefit from the competition.

We expect that the value would likely be a more appropriate factor for a cost-benefit analysis than the duration, albeit a higher value could potentially correlate with a longer duration.

Q8 - where retendering takes place, what safeguards or mitigations would need to be implemented to enable bidders to be comfortable about the level playing field between incumbent OFTOs and other bidders?

Potential bidders are likely to be concerned about perceived conflicts of interest, but it may not be practicable to fully ringfence an OFTO bidding team from the remainder of the OFTO. This will require further consideration, especially to ensure arrangements are equitable when compared to future onshore competition arrangements. If full ringfencing is not in place then it is important that there are alternate arrangements to ensure that the incumbent OFTO does not have access to any relevant information which is not made available to other bidders and that the incumbent OFTO does not have any other potentially unfair advantages over other bidders.

Q9 - are the timelines proposed practical? Do any of the timings need to be extended or reduced, and if so, why?

We think that generators and OFTOs are likely better placed to provide advice on this question, but an intuitive view is that the proposed timelines are reasonable. With regard to our response to Q5, this could potentially give the OFTO enough certainty for timely investment to facilitate an extended revenue period so long as no new consents are required. Additional comfort would also be provided if the generator is providing some form of commitment or security in relation to the additional investment as discussed in our response to Q4.

Q10 – should there be only one extension period granted, or do you think that if the process is established, that more than one extension could be possible for the same OFTO asset?

We think more than one extension should be possible as at the end of an extended revenue period the generator could (in theory) continue to be commercially viable for a further extended period of time on the same basis. However, this highlights the need for further policy consideration in relation to whether a generator is simply extending the life of their existing wind farm or if they are materially enhancing the capability of that wind farm (or even installing a new wind farm entirely), which would require a significantly longer extension.

For example, if an existing wind farm is installing new turbines and significantly increasing their export capacity, in turn requiring significant new investment in the offshore (and potentially onshore) infrastructure, would the outcome of this consultation remain appropriate in such circumstances? Or, would a new offshore tender process commence with the existing offshore infrastructure then being decommissioned, or even repurposed? As detailed in our response to Q7, the above demonstrates that it may be beneficial for a robust cost-benefit analysis process to be implemented to determine the most cost-effective extension period.

Section 3.3: The tender revenue stream for any further regulatory revenue period

Q11 - we would welcome your views on which of the proposed cost mechanisms ("building blocks" or "cost plus") you consider would be more appropriate for establishing a revenue stream for the extension period, or if an alternative should be considered?

We imagine the cost-plus method would also need to identify the costs for each of the building blocks to set the costs against which a margin will be applied, in addition to the building blocks method. In addition, is the building blocks method to be set ex-ante whereas the cost-plus method is to be set ex-post? If so, would it be appropriate to also introduce some form of adjustment or gain share mechanism for the extension period for the building blocks method so that any outperformance on the costs by the OFTO is shared with consumers?

We also assume that there will be a margin associated with the building blocks method too and if this is Ofgem's intention how will this margin (and for the cost-plus method) be set for the extended revenue period? Will it be directly set by Ofgem if extended with the incumbent OFTO and via the competition if one is to be undertaken? Will this apply to all tender revenue stream components or will some components be set via other mechanisms?

We would welcome further detail on each of the proposed cost mechanisms in future in order to be able to provide a more informed view on the most appropriate mechanism.

Q12 - should there be a set cost mechanism for determining the TRS for any future regulatory revenue period across all projects? Or should the cost mechanism be determined on a project by project basis, depending on the required extension length and risk profile?

In respect of both a competitive process and a bilateral extension process it is likely possible to design a standard, flexible process for each of these routes.

However, as acknowledged in the consultation, there could be OFTO-specific circumstances that will need to be considered when setting an appropriate tender revenue stream for an extended revenue period. Therefore, whilst a preferred cost setting mechanism could potentially be applied across all projects, this should have the flexibility within it to address OFTO-specific issues, such as differences in risk profiles.

Q13 - are there any additional cost elements that you think should be considered when Ofgem is calculating the tender revenue stream for a further regulatory revenue period?

The consultation implies this is already being considered but there may also be a cost of debt associated with the new investment depending on the financing arrangements. In addition, as per our response to Q16 below, where there are new decommissioning costs these may also need to be considered by Ofgem.

Q14 - what market value (if any) do you think the OFTO assets will represent at the end of the regulatory revenue period? What are the component parts of this value?

We think current and potential future OFTOs are likely to be best placed to respond to this question. An intuitive view is that the assets may potentially have some residual value if they can be used elsewhere for their remaining technical asset life. If not, as stated in the consultation, there will potentially be a scrap value for those assets. OFTOs may have taken some residual asset value risk when bidding for the asset originally and if this is the case we imagine OFTOs will expect and plan to benefit from any actual residual asset value in these circumstances.

Other than the above, there will also be a market value for the assets if there is an associated regulated revenue stream related to those assets, as is being considered by this consultation. This will be valued based on the expected risks and return associated with those regulated assets. The position on residual asset value risk in this context may be different to that above as the assets should (in theory) be fully commercially depreciated at the end of the original revenue period, meaning there would be no commercial residual asset value, noting there could be some actual residual asset value as above. If the OFTO has taken some residual asset value risk then that will likely complicate both a bilateral extension discussion and a tender process in respect of those assets.

Section 3.3.1: Decommissioning fund

Q15 – do you agree that decommissioning funds and liability should be transferred across in full to any new OFTO?

If the incumbent OFTOs are responsible for any decommissioning costs then they would likely receive a windfall gain in the event that they were relieved of their obligation to decommission without a corresponding downward adjustment in their tender revenue stream within the existing revenue period. However, in practice it might be difficult to determine the actual cost of decommissioning to allow such a transfer value to be agreed between the incumbent OFTO and the incoming OFTO. The value of the fund will be based on estimated costs rather than actual costs so a reconciliation process may be required. If this is the case, consideration is then needed for how such a process would be determined and progressed in future.

(This is one of the competition complexities referred to in our response to Q6.)

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Q16 - do you expect decommissioning costs to be higher after the period of an extension or similar to those expected after the initial regulatory revenue period?

We think that generators and OFTOs are likely better placed to provide advice on this question, but an intuitive view is that decommissioning costs will be the same as fundamentally the same asset is being decommissioned but at a later date. The costs will however be affected by other factors such as supply chain changes or inflation, but these impacts could potentially already be (at least partially) accounted for within existing arrangements.

However, this would not apply if the new investment resulted in new construction as this could then increase the decommissioning costs in a way not accounted for within existing arrangements and decommissioning plans.

Section 3.3.2: Financial Security

Q17 - do you agree that, in the event of an extension, the incumbent OFTO should pay any availability liabilities due at the end of the original regulatory revenue period?

Yes, although we note the point that the availability incentive security requirements are likely to be much lower due to the lower tender revenue stream within the extension period. As a result, the strength of the availability incentive could potentially also be reduced throughout the extension period. Ofgem may wish to consider to what extent this is a risk and whether (for example) some of the original regulatory revenue period security could (and should) be kept as additional security for the extended revenue period if that were to be the case. However, if this were to be the case, any incoming OFTO would also need to place equivalent security over and above the value required under the existing standard licence conditions to ensure equitable treatment of OFTOs within an extension period in respect of security requirements.

Whilst we do not have a strong view on this point, we wanted to raise it as a question to ensure it has been appropriately considered by Ofgem due to the importance of the availability of the offshore transmission assets. There may also be policy interactions with the position on insurance which should be considered by Ofgem.