Ofgem : by email to: offshorelicensing@ofgem.gov.uk

12th April 2021

Dear Stephen,

Offshore Transmission Owner (OFTO) End of Tender Revenue Stream – Consultation concerning policy development

EDF is the UK's largest producer of low carbon electricity. We operate low carbon nuclear power stations and are building the first of a new generation of nuclear plants. We also have a large and growing portfolio of renewable generation, including onshore and offshore wind, as well as coal and gas stations and energy storage. We have around five million electricity and gas customer accounts, including residential and business users. EDF is committed to building a smarter energy future that will support delivery of net zero carbon emissions, including through digital innovations and new customer offerings that encourage the transition to low carbon electric transport and heating.

We welcome this consultation and its many detailed questions on policy around the end of the tender revenue stream. We attach our replies to each question in turn. You will note from these replies that we do not generally favour re-tendering post TRS, preferring an extension for the existing OFTO. The assets must be regarded as fully depreciated at this point.

I confirm that this response may be published.

Yours sincerely

Paul Mott, EDF Energy

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Offshore Transmission Owner (OFTO) End of Tender Revenue Stream – Consultation concerning policy development : EDF's response to the questions posed

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.

These suggested health review timeframes sound appropriate to allow time for planning the post TRS actions/way forward.

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.

EDF believes that the asset owner – the OFTO – should be responsible for the health review of its asset; however, outcomes from the OFTO review should be available to the connected generator(s) in order for them to assess future risk to the export availability and understand the condition of the asset they are paying for, that connects them to MITS.

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

The OFTO should be responsible for the costs associated with the health review of the asset, as there will be a potential (subject, if it is so decided, to competition) ongoing benefit to the OFTO under TRS extension scenarios.

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

It might seem reasonable that developers, on seeing the asset condition report from the OFTO 5 years ahead, then signal their own future intent post TRS. Based on asset health reviews, there may be a need to further invest in the OFTO assets, to ensure that these can continue to operate beyond the existing regulatory revenue period. If the extension of the cable financing, instead of its decommissioning, is only to service that generator, then a guarantee/securities could reasonably be required, as otherwise neither the current OFTO nor any other would take on at a reasonable rate of return, the extension post TRS. Absent any such guarantee, the rate of return would have to be much higher, so the connected generator would still pay out.

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

The funding of the asset improvement should come from the OFTO as asset owner and beneficiary of the extension.

Q6 – In the event that retendering the assets is appropriate, we would need to ensure that any retendering process is fair and that mechanisms are put in place by Ofgem to ensure that incumbent OFTOs do not enjoy an unfair advantage. Should the tender revenue period be extended with the incumbent OFTO, or licences retendered through open competition?

We would question the approach of retendering if it is only to be for a very few years; might extension make more sense in most cases, subject to an acceptable rate of return ? The value of the asset is to be regarded as negligible post TRS, as the asset must be regarded as already depreciated and of very little alternative/recycling value.

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?

EDF does not think that a threshold required, so long as the breakdown of the proposed TRS for the extension is reviewed by Ofgem and its advisors.

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?

We are not convinced that re-tendering is the right approach

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

The timescales proposed seem logical

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?

EDF sees no reason not to extend further, if this aligns with the Generator's aspirations.

Q11 – Ofgem have currently identified two different cost mechanisms that could be used in any further regulatory revenue period to award an economic and efficient tender revenue stream for OFTO licensees. "Building blocks" would involve costs such as: the operation and maintenance of transmission assets; insurance; actions required to extend the lifetime of the assets (depending how the investment was raised); tax; leasehold costs; and maintain any additional expenditure needed to the same level of

decommissioning reserves. Insurance costs may be higher in this period, but overall costs in the extension period should be considerably lower than those in the current regulatory revenue period.

The other identified approach is "cost plus", whereby costs previously forecasted by the OFTO and agreed by Ofgem in the previous period are reimbursed plus a measure of return based on a detailed cost assessment and evaluation of economic and efficient expenditure.

This method would involve a more frequent and in-depth engagement between the OFTO licensee and Ofgem. This would allow for greater flexibility and allow the overall cost profile to be more closely monitored, and the extension period to be reviewed at more periodic intervals, for example 24 or 36 months. ***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?***

The "building blocks" approach would at this stage seem to be the more straightforward. We will study others' responses to this question for their insights.

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 our view, this would need to be on a project by project basis

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?

No

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?

This would be dependent on the condition and design life of each component, but as Ofgem said in its March 2009 consultation for tender round one projects, "at the end of the 20-year revenue stream the OFTO assets would be fully depreciated and revenues to the OFTO would cease". Moreover, the assets will have very little recycle value outside of their current situation.

Q15 : Each OFTO must establish a fund sufficient to decommission the transmission assets at the end of the regulatory revenue period. If the amount held in the decommissioning fund exceeds that required, the OFTO can have back the difference. If the decommissioning costs are greater than projected, the OFTO will make up for the shortfall. If the regulatory revenue period is extended with the incumbent OFTO, then the OFTO would continue to hold the decommissioning fund and liability, and any adjustments needed to the level of the fund would be factored into the revenue stream for the extension period. If a new revenue period is granted to a new OFTO licensee, then the decommissioning fund would be transferred across from the old to the new OFTO which becomes responsible. Bidders should confirm that all the decommissioning costs have been fully funded at the end of the regulated revenue period and will be

transferred. ***Do you agree that decommissioning funds and liability should be transferred across in full to any new OFTO ?***

We believe that liability for funding of decommissioning should sit with whichever party is the current OFTO, in the manner you describe.

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

Decommissioning costs are unlikely to change significantly over the period of the extension. The technology involved in uncovering and removing an entrenched cable from the seabed will be in essence, the same as the years pass. Technique a little may improve as the numbers ripped out, increase.

Q17 – Under amended standard condition E12-J4 of their licence, OFTOs are required to procure an amount equivalent to 50% of their annual regulatory revenue stream as financial security, four years prior to the end of the revenue stream, to cover any availability liabilities due following significant outages in the last five years of the regulatory revenue period. The OFTO (whether incumbent or new) would then need to make the necessary adjustments to the financial security (required by amended standard condition E12-J4) so that it has sufficient funds to cover any availability liabilities outstanding at the end of the further regulatory revenue period. ***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, we agree that the incumbent OFTO should pay any availability liabilities due at the end of the original period.

Q18 – Stakeholders have indicated that the insurance market has hardened in recent years, and that a number of the tender round one OFTOs have lost LEG3[1] full (or equivalent operational all-risk) insurance cover. One approach here might be to allow OFTOs to decide how best to insure their assets during the extension period, while meeting any minimum legal requirements (including under relevant leases and consents). An alternative option could be for OFTOs and the insurance industry to find a wider solution where (for example) cable insurance risk might be removed entirely through the creation of a mitigation portfolio product administrated by a third party. ***Are there any indications that insurers are willing to reinstate LEG3/06 exclusion clauses or equivalent (where this has been removed) after a period without further failure events? If so, how long might that period be?***

If "period without further failures" is in reference to a known defect on e.g. an export cable, then if insurers have incurred losses relating to the cover given under LEG 3, it would be very difficult for the insured to get cover reinstated in relation to the known defect. Insurance revolves around fortuity (meaning that an insured cannot be held to have anticipated the loss); if there is no fortuity, then insurance cover will normally exclude a claim. If a defect is known but is not interfering with operations, then insurers would not usually offer cover in relation to that defect when stated to them. This is a known risk.

[1] LEG3 stands for London Engineering Group; A LEG3 insurance exclusion, means an exclusion from claims of the 'improvement consequences' costs of a defect

Looking at this from the insured's point of view, if the insured entity has gone a long time without further failure events, and then does incur a loss event, a prudent insured party should undertake a full root cause analysis, and use it to take steps to ensure that the same event cannot happen again, instead of attempting to insure against it.

Q19 – noting the difficulty of forecasting the insurance market, what are your views on the likely availability and cost of LEG3/06 exclusion clauses (or equivalent) for the period of any further revenue period?

LEG defects clauses should only apply to Construction All Risk policies (and the maintenance and defects correction period). Operating policies should not have any restrictions concerning defects. Generally speaking, defects will manifest themselves within the first five years of an asset's life. As the LEG clauses relate to damage from a defect, the older the asset becomes the less likely it is that a defect will manifest.

Q20 - is there a need to move away from LEG3/06 (or equivalent) insurance clauses in any further revenue period due to the age, suitability, and specific nature of this type of cover for ageing assets?

We would be supportive of a move to allow OFTOs to manage their own insurance risk, within minimum legal requirements. We would also be supportive of a move to allow OFTOs to manage their own financial risk according to the risk appetite of the firm, within minimum legal requirements. Insurance is a risk financing mechanism; if the OFTO chooses not to purchase cover, then this should be considered when determining any claims/requests it may make for income-adjusting events.

Q21 – Do you consider that a more centralised solution for cable insurance risk might be required? Why? Would this bring confidence back to the insurance market and attract new investors to the OFTO extension asset class?

We would be interested to explore this further. We assume that this could entail the establishment of some kind of offshore cable mutual insurer. There might be an argument that this would not solve the problem, but could merely re-focus it elsewhere. The problems we are seeing in the insurance market currently are a push back against how insurers have been treated in the past. The burden of dealing with the financial issues associated with cable failure has fallen to them – insurers inadvertently underwrote efficacy and technology risk for cable manufacturers, and there were a number of claims.

Other solutions need to be considered; ideally, cable buyers should pressure manufacturers to widen the scope of their warranties and include "in and out" costs as standard.

Q22 – would operating the OFTO assets with minimal insurance to first failure be a viable option for higher risk assets with uncertain futures?

No, we don't think so. If an OFTO purchased minimal insurance until it had its first loss then insurers would view this as rather a selective approach. If the party is seen to be coming to the market only when it has

issues, the premium will be higher. The approach should be seen as one of partnership and of pooling of losses.

In quite a lot of insurance claims, it is difficult to pinpoint an exact root cause. Most loss adjusters will say what they think is probable and whether it is likely that the root cause is an insured peril. If a party does not buy "all risks" cover, then it is narrowing the opportunity to make the "probable" cause of a claimed loss, an insured risk under its policy.

Q23 - are you currently exploring or investigating any other potential models or approaches to insurance that maybe appropriate for an OFTO asset during any further revenue period?

No, we are not.

Ofgem seem to be focussing on legacy cable issues at older windfarms, which are less relevant to new ventures. The standard of engineering on more recent projects has improved and the sector is now seeing less cable claims from defect on these more recent projects. Claims do still arise from contractor / installation error, but defects are becoming less of an issue.

The model for the future has to include other factors, not just insurance. As mentioned in our answer to Q21, better risk management, better engineering, and better warranties are all part of the preferred way forward. Perhaps even the adoption of agreed standards for cable manufacture for UK assets, with some form of prescribed/regulated minimum of cover from a warranty.

EDF
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