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Date: 28 June 2021

Dear Richard,

Hornsea 2 - Initial Transfer Value and Cost Assessment Process

Introduction

In order to commence the Enhanced Pre-Qualification (**EPQ**) stage for the Hornsea 2 Offshore Wind Farm Transmission Assets (the **Project**) we¹ will publish the EPQ document and Preliminary Information Memorandum (**PIM**) (together the **EPQ Documentation**). In the EPQ Documentation we will include the Initial Transfer Value for the Project for the purposes of the bidders' EPQ submissions.

The purpose of this letter is to set out to you:

1. the Initial Transfer Value for the Project to be referred to in the EPQ Documentation; and
2. an overview of the cost assessment process.

Initial Transfer Value

In your cost submission of 5 May 2021, you provided us with an initial forecast of costs for the development and construction of the transmission assets for the Project. We understand your forecast costs to be approximately £1.21bn, which is comprised of:

- Capital expenditure (including contingency): £1,027.8m
- Development costs (including transaction costs): £69.0m
- Interest During Construction (IDC) costs: £115.7m

The Initial Transfer Value is **£1,212.5m** and this figure will appear in the EPQ Documentation.

These figures are based on your chosen offshore boundary point located at the 66 kV MV switchgear incomer termination connecting from the grid transformers on the offshore substation (**OSS**) and the first gas barrier zones on both the main and reserve 400 kV bus bar. As a result of the chosen boundary point, we understand that the following assets will

¹ References to "Ofgem", "the Authority", "we", "us" and "our" are used interchangeably in this letter. The Authority is the Gas and Electricity Markets Authority. Ofgem is the Office of the Authority.

transfer to the Offshore Transmission Owner (**OFTO**):

- *a single offshore substation (OSS)* – including six 220/66 kV transformers, auxiliary transformers, 220 kV gas insulated switchgear (**GIS**), 66 kV switchgear, 66 kV cables, three 220kV shunt reactors, and auxiliary systems;
- *one reactive compensation platform* – including three 220 kV shunt reactors, auxiliary transformers, and a 220 kV GIS;
- *three offshore export cables (with associated fibre optics)* – all of these circuits are 220 kV, and when combined come to a total length of 384 km. The North West circuit is 128 km long, the South West circuit is 128 km long, and the North East circuit is 128 km long. Each circuit is divided into near shore (66km) and far shore (62km);
- *three onshore export cables (with associated fibre optics)* – onshore 220 kV underground cables of 38 km route length.
- *a new onshore substation* – including three 400/220 kV transformers complete with 400 kV and 220 kV GIS, two 400 kV shunt reactors, three 220 kV variable shunt reactors, three STATCOM (dynamic reactive compensation) plants, two 400 kV harmonic filters, and three 220 kV harmonic filters and low voltage auxiliary systems;
- *two 400kV GIS bays* – positioned within an external building to the existing National Grid Electricity Transmission (**NGET**) Killingholme substation;
- *Two 400 kV cables* – two 400 kV circuits, circa 282m long, linking the onshore substation to NGET's Killingholme substation; and
- *SCADA* – including OFTO SCADA servers and separate OFTO SCADA network.

We note that this boundary point and the assets transferring may be subject to change at a later date, and that this may result in changes to the cost estimates and/or assessment described in this letter.

You should note that the use of this information is not an endorsement by us of the basis on which you derived your estimated costs or any assumptions or methodology that you used in your calculations. It is simply being used for the purpose of commencing the tender exercise.

Cost Assessment Process

The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 (the **Regulations**) provide the legal framework for the process which Ofgem runs for the grant of offshore electricity transmission licences. The Regulations² set out the requirement for the Authority to calculate, based on all relevant information available to it at the time, the economic and efficient costs which ought to be, or ought to have been, incurred in connection with developing and constructing the offshore transmission assets in respect of a qualifying project.

Where the construction of the transmission assets has not reached the stage when those transmission assets are available for use for the transmission of electricity, this calculation will take the form of an estimate of the costs which ought to be incurred in connection with the development and construction of those transmission assets. This estimate is the

² Regulation 4(1).

Indicative Transfer Value (**ITV**) for the Project which will be included in the Invitation to Tender (**ITT**) documentation. This value will be used for the Tender Revenue Stream (**TRS**) bids submitted by bidders at the ITT stage.

Where construction has reached the stage when those transmission assets are available for the use of the transmission of electricity, the calculation of costs will take the form of an assessment of the costs which ought to have been incurred.

Data Collection

Under Regulation 4(3) of the 2015 Regulations, we may request information from you for the purposes of enabling bidders to take into account the most accurate ITV in order to meet any requirements of a particular stage of the tender process.

Through the cost assessment process you will be required to complete cost reporting templates and cash flow schedules. These will relate to the forecast and actual costs of construction contracts, development costs, and financing costs related to the development and construction of the transmission assets being transferred to the Ofgem.

You may also be required to provide supporting evidence to substantiate these cost submissions including, amongst other things, contract documentation (including completed variation orders where necessary), supplier payment lists, and asset schedules.

We remind you that if you fail to provide such information to us this may constitute an event of disqualification under the 2015 Regulations.

Updated Cost Estimates

During the EPQ stage, Ofgem will review and analyse the cost information that you have provided. We may request further information from you to calculate the ITV.

In calculating the ITV we will conduct an initial forensic accounting investigation. This may require our external advisers to visit your offices and will involve checking your internal documents, contracts, and supporting information. This may also require Ofgem to visit your offices to ensure that all the relevant information is available prior to our external advisers' visit. We will contact you as part of the ITV process to discuss this further.

In conducting our analysis for the ITV we will use project information gathered from offshore transmission developers to compare costs between projects and identify projects that are cost outliers when compared to the range of other projects. Where cost outliers are identified, we will liaise directly with you to ascertain the reason for this. In addition, we may indicate to our technical consultants that the cost outlier requires further investigation into whether the proposed cost is economic and efficient.

We will confirm the ITV to you in writing, along with an explanation of our rationale in reaching this estimate of costs. We may also provide further updates to the ITV during the Preferred Bidder (**PB**) stage for the purposes of inclusion within the PB's TRS.

Assessment of Costs and Final Transfer Value

We intend to commence the process for the assessment of costs during the PB stage. This assessment of costs shall be used by Ofgem to determine the value of the transmission assets to be transferred to the successful bidder in respect of the Project (the final transfer value determined by Ofgem).

Next steps

We will shortly be in contact with you to set out further details in relation to the cost assessment process.

If you have any questions regarding this letter, please contact Phill Heyden on 0207-901-0516 or via email (Phillip.heyden@ofgem.gov.uk) in the first instance.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jourdan Edwards', is positioned above the printed name.

Jourdan Edwards

**Head of the OFTO Regime
Systems & Networks**