OTEG Adoption Group

Issues for consideration by OFGEM and DTI following meeting of the 20th October

As previously identified in the Adoption Group papers submitted, there are two main areas of concern:

- Firstly, the "legal issue", being the exposure the developers have to commencing an activity that they know is going to be regulated/prohibited, and which they have no assurance that they will be licensed to conduct for themselves (indeed, the onshore model suggests that they would not be entitled to); and
- Secondly, the "price issue", being the exposure the developers have to OFGEM's *ex post* determination of the regulated price in a new market and as to how this translates into an acquisition price for the assets. This issue cannot be separated from the transmission charges uncertainty, as it is the combination of the divestment price/return and the transmission charge will determine whether the new regime will impact positively or negatively on the economics of offshore wind development.

The two issues compound, of course: the first may mean that the Projects are forced to sell the asset on or before commissioning, and if the price risk also materialises the downside exposure will be crystallised immediately (with no ability to recover over time).

The Adoption Group is unequivocal that these uncertainties are expected to have a direct bearing on the ability to finance these assets in the bank markets and on equity investors or developers who may choose to abandon or delay development, or alternatively switch their focus to countries with more clarity.

1 The legal issue

The OTEG Adoption Group suggest that a clear, early indication that the assets will not become legally stranded is both important and achievable, not least because there does not seem to be any intention on the part of Dti or Ofgem that this outcome might be allowed to result.

Issues which have been raised include:

1.1 The current process timetable assumes that the Energy Act powers are passed and then licences are awarded: how does this work for an asset which is already exporting power at the relevant time (Barrow, for example)?

1.2 Can assurances be given that the assets could complete power transmission activities associated with commissioning without requiring a licence? This would allow developers currently pursuing a whole-project construction strategy, for sound risk and cost reasons, to continue to do so.

1.3 If the award of a licence was problematic or delayed, would the project be assured of the necessary temporary exemption: i.e. could it be made clear that for so long as no licence was awarded, existing activities within the scope of the regulation at the time the Energy Act powers are passed are exempt?

1.4 What would the generator's position be if the relevant Transmission Operator ("TO") lost their licence? Is there a TO of last resort concept that will apply to these assets?

What other mechanisms can be put in place to ensure that the assets cannot become stranded? Is it, ultimately, better to allow the possibility of generation projects operating the related transmission assets, notwithstanding normal ring-fencing principles?

Some of these questions would, no doubt be addressed by suitable transitional arrangements and some of them are more fundamental. It would certainly be helpful if all these questions could be explored in the consultation document in the context of seeking an appropriate solution.

However, whilst a positive indication in the consultation paper that these issues are recognised and are being addressed is clearly helpful, even if the decision document concludes these issues positively, it may neither be early enough, clear enough or strong enough comfort to allow these projects to proceed as planned. This has been emphasised by the Thanet project, but is also likely to be an issue for Gabbard. All of the developers are keen to avoid a situation where getting clarity on the transmission licensing process becomes the critical path item.

2 Proposal in respect of the legal issue

The comfort letter option is, understandably, a sensitive one, but, for the above reasons, remains a strongly preferred option of the Adoption Group. The suggestion would be for an open (published) letter confirming that:

2.1 Ofgem/Dti policy is that the new regime should not result in offshore wind generation assets being stranded, i.e. in the situation of having no licensed operator in place and no legal right to operate the related transmission assets themselves;

2.2 Proposals [will be/have been] included in the consultation document to address this issue and, while the decision on the detail is outstanding, provisions to ensure that this is cannot be the case will be included in the regulatory framework in the long term;

2.3 Until such arrangements become law, Ofgem/Dti confirm that the transmission of electricity to its onshore connection point from any relevant offshore windfarm which was operating or had committed to construction obligations at the time that the Energy Act powers are enacted will not become a prohibited activity prior to the licensing of a Transmission Operator for that asset and the completion of the necessary adoption process; and

2.4 The undertakings in the letter are intended to provide a significant level of certainty to developers, which is recognised as essential in order for developers to procure the necessary financing for the Project. Ofgem/Dti acknowledge that the developers, their investors and financiers will rely on these undertakings for that purpose.

If this proposal was acceptable, we would be happy to assist in preparing a draft of the proposed letter.

Whilst not directly related to the OTEG process, we note that there is also an issue with licensing of the generation activity by projects outside territorial waters which is comparable in many ways, and could be resolved in the same way.

3 The Price Issue

The Price Issue is rather more complex and the debate at the meeting was both as to whether this is a risk the projects can/should bear and as to how one might protect the projects, if minded to do so.

With respect to the question of whether this is a risk the projects should bear (and without wishing to go over ground previously discussed), the OTEG Adoption Group's key points are that:

3.1 At present no decision has been made as to the direction, form or structure of the proposed price control or any relevant considerations (including questions such as the licensed areas): this is not comparable to a new development in an onshore context where the price control mechanism is well understood.

3.2 Even had such decisions been taken, there would be no history of operating the regime on which investors could rely to take a view.

3.3 The SQSS may provide some guidance, but as a *minimum* standard, provides little comfort as to whether investment in excess of this standard is likely to be acceptable as economic and efficient or not.

3.4 In those limited areas where the lending market has been willing to take the risk of *ex post* determination of the regulated return:

3.4.1 the proportion of the financing which was dependent on such determination was substantially less than half that which the transmission assets represent in an offshore windfarm context, and was limited to capex overspend;

3.4.2 the assets were characterised as strategic assets, which offshore wind is not (at least to the same extent);

3.4.3 the regime was well known and the relevant sponsors/Ofgem had an established track record in relation to the relevant asset class;

3.4.4 the assets were part of an ongoing regulated business and therefore subject to reassessment at subsequent RAV reviews as part of the whole. Here, the core business is unregulated and if the regulated return is less than expected that loss is likely to be crystallised by the generation project at completion; and

3.4.5 the overall risk profile of the assets being financed was considered low risk: that is not true of offshore wind projects.

Accordingly, the OTEG Group and their advisors consider that, in this case, *ex post* determination is not a risk which lenders (or the private equity markets) will accept and accordingly the projects will be unbankable without further clarification. Indeed, it is not clear why Sponsors would continue to develop the Projects without further clarity being provided.

3.5 Even if investors and their lenders could get comfortable as to the adoption price, there is no clarity on the extent to which that same price will be reflected in the transmission charges passed back to the generation projects.

4 Proposal with respect to the price issue

As with the legal issue, it will clearly be helpful to see these issues discussed in the consultation paper, but to await the outcome of that process and rely on it alone is unlikely to be sufficiently to allow these projects to be constructed on schedule.

Accordingly, the OTEG Adoption Group believe that it is appropriate to discuss an *ex ante* assessment of the proposed projects leading to a clear statement from Ofgem as to the acceptability of the proposed investment. An objection was raised that such an approval would give the projects *carte blanche* to incur expenditure on the basis that it would all be a pass through to the regulated tariff. That is not the intention. It is understood that developers would be getting approval on the base case project design and cost, with subsequent variations either needing to be discussed with Ofgem or something on which developers would have to take the risk. It is also understood that Ofgem would be entitled to reduce the RAV by reference to the project's actual costs, if less than expected.

To expand on the proposal, assuming there was a commitment to such a process in principle:

4.1 Ofgem would be encouraged to enter into a dialogue with the relevant projects as soon as possible (and while the consultation was ongoing) with respect to their likely information needs, how this should be presented, general criteria, etc.

4.2 Developers would engage immediately in providing such information.

4.3 Ofgem's due diligence would proceed in parallel with the consultation process with a view to providing, as soon as possible and no later than the date of the decision document on the consultation, written confirmation (not by way of open letter) that:

4.3.1 Ofgem is willing to give a preliminary view on whether the proposed costs of construction and maintenance of the Transmission Assets satisfy the criteria/principles (expected to be) set out in the decision document;

4.3.2 To enable Ofgem to form its view, it has been provided with, and has reviewed, various supporting documents;

4.3.3 On the basis of its review of the documents, Ofgem can confirm that the design and costs described in the supporting documents, if incurred in accordance therewith, do satisfy these requirements and that the RAV extends to the anticipated cost of funding the debt and equity investment contemplated in the relevant financing plans;

4.3.4 Accordingly, the regulated return permitted for any TO acquiring such assets, on the assumption that the Energy Act powers are passed, will be based on a RAV not less than those being approved (or the actual costs of the developer, if less) and that the relevant TO would be required, as a condition of its licence, to adopt such assets at such cost;

4.3.5 The undertakings in the letter are intended to provide a significant level of certainty to developers, which is recognised as essential in order for developers to continue to advance the projects to completion and to procure the necessary financing for the Project. Ofgem acknowledge that the developers, their investors and financiers will rely on these undertakings for that purpose; and

4.3.6 These undertakings are based on the assumption that the information provided to Ofgem by the developer is and proves to be materially accurate and does not contain any material misstatements or omissions, and is not subsequently varied, in a manner which would have been relevant to Ofgem in forming its views. To the extent that the information provided is inaccurate or contains such misstatements, omissions or variations, Ofgem will be entitled to adjust its views proportionately.

4.4 A key part of the consultation process would need to be the development of the criteria for transmission charging associated with theses assets, including asset life, degree of socialisation (if any), indicative IRR ranges etc. with the intention that, on the decision document being published, it would also be possible to form an informed view of the likely project transmission charges based on the approved RAV.

If this proposal was acceptable, we would suggest that it may be desirable to prepare a brief memorandum confirming all parties' commitment to the process and deliverables. We would be happy to assist in preparing a draft of the proposed letter.

OTEG Adoption Group

27 October 2006