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Our Reference NG/LAD

Dear Colin,

Offshore Electricity Transmission – A Joint Ofgem/BERR Policy Statement

We welcome this opportunity to comment on this policy statement. The establishment of a fit for purpose offshore electricity transmission regime is a key requirement for meeting the nation's renewable energy environmental targets and we in National Grid are keen to play our full part in this activity.

National Grid's interests in the offshore transmission regime span our duties as National Grid Electricity Transmission Ltd (the designated offshore system operator and onshore system operator and transmission owner) as well as our interests as a potential investor and developer of offshore transmission assets. Our comments on the policy statement from our perspective of system operator seeking to implement the arrangements are the subject of a separate response. This response concentrates on the issues from our perspective of a potential investor and network asset owner.

Concerning the proposed functioning of the regime, we understand the benefits that should be achieved if, in a similar manner to PFI, a competition is used to select OFTOs and determine a fixed revenue stream to fund specified transmission services over a 20 year period. Such arrangements would:

- Provide an objective basis for selecting OFTOs.
- Provide competitive pressures on bids (and hence determine efficient revenues to fund OFTO activities).
- Ensure the main risks fall to the OFTO (who should be the best party to manage most of them).
- Offer long-term revenue certainties which should give scope for obtaining finance at low costs.

However, it is clear from the policy statement that the proposed regime differs considerably from PFI in some important respects:

- 1) Rather than PFI long-term contracts (which determine rights and obligations at the outset and fix them legally), it is proposed that the existing onshore regulatory mechanisms are used (albeit with clearly specified OFTO outputs). These mechanisms provide significant scope for regime change by regulatory authorities (but the normal compensating protection for licensees formulated around regular price reviews would not be applicable). Unless long-term stability of the offshore regime can match that of PFI there will be significant risk that unfavourable costs of capital will result, bid premiums will be untenably high and developers may not wish to bid.
- 2) The competitions for PFI contracts are unbiased by relationships between client and contractor. In the proposed offshore regime, however, there would be a number of advantages that would accrue to OFTOs affiliated with the generator user. The bias implied by the proposed arrangements can be expected to have serious implications for competition (as OFTOs independent of generators will face larger costs and/or risks).

There are also a number of other areas where further work on the proposed policy is required:

- a) The mechanisms for co-ordinating the development of offshore networks and connections (a key reason why a price controlled regime was chosen over the provision of connections by individual users) have not yet been adequately formulated.
- b) The treatment of project timing in bids (which could have important implications on project costs) warrants further consideration.
- c) There are a number of areas where the rights of OFTOs merit better definition (e.g. in the event of contract terminations and re-tendering).
- d) Further development to policy is required to address the requirements of OFTOs in respect of asset transfers under transitional arrangements.

We agree that further industry participation is required to reach a fit for purpose regime. However, this participation should not be limited to codes but must include discussion of the financial implications of the regime and draw on the experience of those, such as lending banks and existing developers in the PFI market, who can quantify the implications of differences from PFI precedents.

We note that the further development of policy and agreement of contractual documents will be very challenging in the current timetable. To ensure all key steps are adequately addressed, the development of a clear and transparent set of go-live criteria is essential.

More details on the issues raised above together with points responding to the questions raised in the consultation document are contained in the attached annex. If you would like to discuss any of the points contained within this response please contact me.

Yours sincerely,

Lewis Dale

Annex – Detailed points on financial matters and consultation questions

At this stage we are unable to establish whether the financial benefits of setting longer-term price controls in competitive conditions compared to using normal regulatory supervision of OFTOs exceed the costs of setting up and operating the processes that will be required. Our comments are therefore aimed at ensuring the benefits from the regime can be realised and the potential dis-benefits minimised. Further work on the as yet rudimentary quantification of these aspects in the regulatory impact assessment would be valuable in ensuring an appropriate regime is developed.

Cost of capital

Internally, we have not yet been able to fully assess the cost of capital implications of the regime or the cost of risk management measures that would be appropriate. Partly this is because there are still a number of key regime details which need to be clarified and also there are a number of issues which are relevant to the effectiveness of the competition that is likely to take place. These issues are summarised below.

Form of regime

During working group discussions Ofgem made reference to PFI contracts as a precedent for the long-term revenue controls proposed. The Ofgem/BERR regulatory impact assessment also makes reference to savings which are expected to match those resulting from PFI schemes. However, it is clear from the policy statement that the proposed regime differs considerably from PFI in a number of important respects. This means PFI project financing experience cannot be directly transferred to the offshore context. It also means that key elements of PFI contract forms will not be transferable and a significant task to develop and assess the new agreements is needed.

Fundamentally, the proposed regime retains all the options in the existing onshore regime for regulatory authorities to intervene in transmission businesses and the wider regime but removes from the licensee the scope to adjust remuneration in the event of developing regulatory practice. The proposed regime does not establish in legal terms the fixed nature of PFI contracts. Rather, the licensee under the proposed regime must rely on the constancy of the regulatory regime overseeing the outputs agreed. The checks and balances to unacceptable regulatory change (i.e. the duty under the Electricity Act for the regulator to have regard to the need to secure that licence holders are able to finance licence obligations, and licensee's rights to refuse price controls and seek determination from the Competition Commission) will not give investors comfort in the proposed regime because there will not be regular price controls despite much longer timescales over which regulatory changes may accumulate.

The one area where the proposed regime seeks to allocate risk to users and consumers, i.e. the obligation to pay revenues in the event of generator insolvency or abandonment, is also likely (as currently formulated) to be the subject of significant regulatory risk for investors. For example, the primary duty on regulators to protect the interests of consumers must give a significant probability that payments for unused/stranded offshore transmission assets will be terminated to the disadvantage of the licensee.

In summary, the proposed regime needs to either fix the contractual parameters for 20 years in a manner similar to PFI contracts or, if regulatory flexibility is to be retained, allow re-openers to make compensating changes to revenues. (Due to the financial unattractiveness of having completely fixed revenues over long-periods, we note that even PFI contracts tend to include some scope for adjustments to reflect changes in requirements or external circumstances.) The current proposal appears to sit somewhere in between these models and the resultant regulatory uncertainty and risk will be unattractive to developers. Given these issues, we believe there is

significant further development of the regime required to minimise regulatory risk. This may entail better fixing licensee obligations (for example, in a manner which more closely matches the PFI model) but must establish how revenue adjustments appropriate to changed obligations will be made.

Scope for competition

A number of aspects of the proposed regime offer OFTOs affiliated with offshore generation developers an advantage over independent OFTOs. These include:

- Access to all local knowledge held by the generator developer (rather than the inevitable subset transferred via the data room and intellectual property purchases).
- Transaction costs and information aspects associated with negotiating generator-OFTO bilateral contracts for additional transmission services.
- Cost of managing operational risks. Enhanced co-ordination between generation and OFTO, including the proposal that performance penalties on the OFTO will be paid to the affected generator, will mean that the portfolio of generator and OFTO will be less risky than if either was kept separate.

As noted in the consultation document, there are important efficiencies to be gained by permitting an active role of generation developers in the specification of offshore networks. However, regime features which enhance the benefits of affiliated generation/OFTO companies reduces the scope for competition by making independent companies more cautious about incurring significant bidding costs in a biased competition. We suggest that this effect could be reduced by:

- 1) Ensuring generator requirements are fully reflected in the specifications for which OFTOs are invited to bid. (Rather than just a specification of minimum requirements as proposed).
- 2) Ensuring there is an opportunity for independent OFTOs to match any variants advanced by affiliated OFTOs.
- 3) Arranging for performance penalties to be shared between the offshore generator affected and other users (in proportion to charge allocation under TNUoS).

Capital Efficiencies

An important property of the offshore regime should be the delivery of capital efficiencies through co-ordinated development. An annual tender window should allow advantageous shared connection solutions to be identified. However, the proposals are unclear as to who will decide whether it is efficient to exploit synergies. Will it be solely a matter for generation developers to decide whether a shared connection is advantageous? Might Ofgem invite tenders for both individual and shared connections (such that the cheapest solution can be chosen by the tender panel)? Alternatively, if OFTOs can propose shared solutions, how will bids of different scopes be assessed?

Associated with the subject of selecting efficient shared designs are the issues concerning the initial funding by generators and subsequent reimbursement by OFTOs of survey and consenting costs for shared facilities. These issues need further development and decision.

Another important topic concerns the phasing of offshore developments. The logistics of developing large offshore wind farms will mean that phases corresponding to construction seasons will be important. Will such aspects be part of the specification? Will OFTOs have

discretion to propose alternative solutions and how will these be evaluated? Incentives for generators to select efficient designs would be considerably enhanced if TNUoS charges specifically reflected the cost of offshore substations and platforms.

Similarly, in terms of OFTO delivery timescales, do all bidders have to agree to deliver in the timescales required by the generator? Who tests that these are reasonable? What if an OFTO bidder can come up with a much lower price by delaying delivery (e.g. to avoid manufacturing bottlenecks or to obtain permits for a cheaper design)?

In terms of the specific questions asked in the consultation document, we would highlight the following:

Chapter 3 Design of Regime

In addition to the main points concerning stability of the regime, areas for further consideration and development include:

- The rights and obligations at the end of the contract need to be better defined. The consultation suggests that Ofgem might wish to re-tender at the end of a contract to use any residual value in the assets. What claim does the OFTO have on any residual value of the assets (which may in part have been maintained by good husbandry by the OFTO)? How do these end contract obligations sit with other end licence obligations associated with decommissioning? The regulatory contract must make end of term rights and obligations clear (for example, by following PFI precedents).
- There is no mention in the consultation of OFTO rights in the event of revocation of the transmission licence or other modification of licence conditions via powers in the Electricity Act. Moreover, the special administration powers for protected energy companies under the Energy Act 2004 mentioned in the consultation mean that all OFTO assets can be effectively sequestered if financial difficulties result. These factors mean that there are severe risks to the business if the revenue stream proves insufficient (for example in the light of actual fault events, penalties and repair costs) and these issues will be very significant in acquiring loans. The procedures for addressing circumstances in which an OFTO fails to meet the various requirements of the licence (for example, the scope for an extraordinary review of the contract) need to be developed and better defined.
- Options for the OFTO to terminate and receive termination amounts in the event that the assets are unused should be specified.
- The potential for bilateral contracts between generators and affiliated OFTOs to provide an undue competitive advantage in auctions should be further explored. Why is a limitation on investment of 20% appropriate? What about the potential effect of non-investment performance-related bilaterals?

Chapter 4 Enduring Competitive Framework

- The methodology for deciding when shared connections should be constructed needs to be clarified:
 - Will it be solely a matter for generation developers to decide whether a shared connection is advantageous?
 - Might Ofgem invite tenders for both individual and shared connections (such that the cheapest solution can be chosen by the tender panel)?
 - Alternatively, if OFTOs can propose shared solutions, how will bids of different scopes be assessed?

- The consultation document proposes that generation developers will fund environmental impact assessments and other costs of obtaining consents for cable routes and onshore connection points. What will be the arrangements for shared connections?
- It is also proposed that the OFTO will reimburse generation developers for (efficiently incurred) connection consenting costs. Will such obligations be defined in the project specifications?
- As well as a process which develops efficient designs for shared connections, the regime will also need to address the efficient design of phased generation developments. The logistics of developing large offshore wind farms will mean that phases corresponding to construction seasons will be important. Will such aspects be part of the tender request? Will OFTOs have discretion to propose alternative solutions and how will these be evaluated?
- In terms of OFTO delivery timescales, do all bidders have to agree to deliver in the timescales required by the generator? Who tests that these are reasonable? What if an OFTO bidder can come up with a much lower price by delaying delivery (e.g. to avoid manufacturing bottlenecks or to obtain permits for a cheaper design)?

Chapter 5 Transitional arrangements

- It is likely that the costs of operating offshore assets (particularly the risk and cost of failures) will depend strongly on their design and construction. OFTOs must therefore have an opportunity to verify that the assets are actually constructed as originally declared and all warranties are valid. What dispute mechanisms will be used if due diligence shows that assets are not as described? Can bids be adjusted in this event? These issues are particularly important if assets and final audits are not completed until after the OFTO appointment competition has taken place.
- The proposed transfer of asset audits needs to satisfy the OFTO about the quality of the transferred assets as well as confirm the final RAV.

Chapter 6 Connection Application Process

- The process by which shared connections and co-ordinated development in environmentally sensitive areas must be defined and decided (see points above for Chapter 4).

Chapter 7 Connection via distribution networks

- It is our understanding that distribution network operators do not provide firm rights to distribution connected generators but rather the deep aspects of the connection are negotiated so that the required reliability and performance required by the generator are obtained. We understand that the proposals are for such design discussions to be undertaken by the DNO and GBSO. However, some aspects of the connection design will depend on characteristics of the OFTO system (for example, electrical characteristics associated with reactive power and operating characteristics associated with available switching facilities). For this reason we suggest the procedures will need to include participation by the OFTO and design and operating requirements at the DNO/OFTO interface will need to be documented and agreed.

Chapter 8 Charging, Access and Compensation

- We agree that the current governance arrangements should continue to be used to develop transmission charging and access arrangements.
- In terms of incentivising appropriate offshore connection designs (particularly in respect of phased developments), increased cost reflectivity of offshore platform and substations may be desirable and should be explored.
- While we understand the logic of directing OFTO penalties to the generators affected, particularly in the absence of GBSO compensation payments for first circuit outages, there is less chance of distortion and bias between affiliated and unaffiliated OFTOs if penalties for basic outputs refund customers in proportion to their contribution (via TNUoS charges) to the OFTO revenue stream.

Chapter 9 Technical rules

- The definition of OFTO obligations at the interface with distribution networks requires codification. See point relating to Chapter 7 above.

Chapter 10 & 11 Implementation Issues & Timetable

- The proposals for ongoing industry engagement are essential to the delivery of a workable regime which delivers the required outcomes. As well as the codes, licences and regulations areas mentioned, we suggest there is significant value still to be gained from discussions with potential OFTOs, banks and other financiers / PFI developers about the nature of financial risks and the bid premiums implied. As part of the bidding and price control work streams we understand that Ofgem sought the views of certain banks and financial institutions. It would be very helpful to have an opportunity to discuss the work and findings of those work streams.
- We are concerned that the rights and options available to OFTOs under the regime have so far received inadequate consideration. This may deter competition from OFTOs independent of generation interests and hence increase the costs faced by GB consumers. Time needs to be set aside for addressing these areas.
- As the chapter on timetable acknowledges the scope for slippage, the implementation process should include the development of go-live criteria and transparent reporting on the status of such criteria.