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Dear Richard,

**Offshore Electricity Transmission – Updated proposals for the Competitive Tender Process
21/09**

Thank you for the opportunity to comment on the tender regulations consultation. This letter will highlight our key points and appendix A contains more detailed responses to some of the specific questions raised.

This response is from National Grid in respect of our interest in becoming an OFTO and potential investor in offshore transmission networks. It has been prepared by the National Grid Business Development team, a separate entity from National Grid Electricity Transmission (NGET).

National Grid OFTO's key issues from a prospective OFTO point of view are:

Level Playing Field (Transitional and Enduring): We are concerned that the recent, significant change to allow offshore wind farm generators to bid for the offshore transmission licenses could create an unfair advantage for them. We highlighted this in November 2008 when we responded to the consultation with similar concerns over whether there was a level playing field for an independent, commercially motivated OFTO as opposed to a generator affiliated OFTO. Fundamentally, the OFTO assets represent about 10-20% of the project cost to the generator but about 80% of the financial risk because if the offshore substation or cable develops a major fault then the Generator earns no income until the OFTO conducts the repair.

The winning OFTO will be the one that makes the most optimistic assessment of the key operational risks for which there is little known experience. It is therefore easier for a generator affiliated OFTO to price in a risk premium that an independent commercial OFTO could not.

We recognise that this is not a specific point about process, but it is highly related. It is a fundamental change and one that will make all prospective independent OFTOs question their ability to compete on an equal footing.

EU Procurement Regulations for Utilities (mainly related to Enduring) – We are concerned that the requirement to comply with the EU procurement regulations is in conflict with the timetable and

procedures for bidding for both the Transitional and Enduring regimes. The sequencing of procurement events and the related time required to work through the necessary procedures and complex negotiations to ensure a fair competition for the supply chain are likely to exceed the time allocated in the OFTO bidding process. We continue to advocate a process that enables much greater engagement with the supply chain earlier on – which in turn will actually support Ofgem’s process better. The latest changes imply an even later engagement by the OFTOs with the supply chain and this will work against the overall process.

Timetable readjustment (Transitional) – The current timetable keeps the twelve month overall timetable but extends the PQ stage by three months. This is at the expense of time to resolve issues from the data room and allow the OFTO the time to negotiate the O&M contracts and obtain a firm insurance quote whilst maintaining EU Regulations compliance. We are therefore concerned that this will put yet further pressure on the ability of OFTOs to reach financial close in Ofgem’s desired timeframe.

Role of the supply chain (Enduring) – We recognise and support the desire to drive the best competitive OFTO solution but remain extremely concerned that the recent intention to prohibit exclusive supplier participation as part of an OFTO bid will seriously undermine the benefits assumed from this move. The likely result is that the supply chain will be unable or unwilling, particularly given the timetable, resource implications and bidding costs, to offer tailored bids to multiple OFTOs which would result in OFTOs receiving the same or very similar bids – so negating the expected benefits. Exclusive supplier participation in bids is standard practice in the PFI/PPP sector and has resulted in innovative and cost effective solutions being delivered on time.

We would welcome the opportunity to discuss any of these points in more detail and are available to meet with you at your convenience.

Yours sincerely,

Mathew Rose

Cc:

Appendix A

Chapter 2

- 2.11 National Grid OFTO welcomes the change to vary the performance standard for each project.
- 2.33 The fourth bullet point states "Construction risk is assumed by the developer for the transitional projects". Does Ofgem envisage that this will mean that the developer will commission the assets and run them for a period of time before transferring ownership to the OFTO? Will issues that occur on commissioning or shortly after be the responsibility of the developer? Clarity on this aspect is crucial to the pricing of risk.

Chapter 4

- 4.11 A qualifying pre-condition is that the developer will have obtained all necessary property rights and all environmental and planning consents. We recommend that Ofgem requires a warranty from the developer to the OFTO that these consents are complete and correct in the model SPA.
- 4.21 The consultation requests views on the scope and level of detail of an engineering report. National Grid would recommend that the developer commission a report on behalf of itself and the eventual OFTO on the standard of planning, design, installation, continued operation and health & safety aspects of the project. The report should be risk based and should highlight the technical issues that would be discovered during due diligence. We recommend guidance is taken from Ofgem's insurance advisors as this report could become a good starting point for discussions with insurers. Fundamentally, this report must have sufficient detail to be capable of use in a project finance environment otherwise the relevance of the report has to be questioned.
- 4.25 The consultation requests views on what remedies could apply if the construction is completed more than twelve months after licence award. We request clarity on "completion of the asset construction". Does this include full commissioning and guarantees over a probationary period as the developer does retain the construction risk (point 2.33)? Projects to date have had slippages due to supply chain constraints, project issues and management of time windows. The best option would be for the developer to not enter the transitional tender until construction had reached a point where they are reasonably certain that construction will be completed during the twelve month tender process. The alternative could be a re-opener to deal with any subsequent changes (up and down) in costs etc.
- 4.38 We are supportive of a model SPA with the ability to negotiate terms. Like early PFI/PPP, this is a new sector which will require, and benefit from, the parties ability to maintain a degree of flexibility as new issues emerge during the process.

Chapter 5

- 5.25 Please see our comments in the main letter.
- 5.33 With regard to the prospective OFTO being scored against a desired project IRR at the QTT stage, what are the implications should the prospective OFTO materially increase their project IRR when submitting a bid? Setting aside the potential for gaming, a prospective OFTO could legitimately set out their desired project IRR but, following actual due diligence, conclude that the actual risks are greater than expected and need to increase the hurdle rate.
- 5.55 The proposed anonymous electronic hub and spoke approach to data room questions will not allow prospective OFTOs to interview key developer and supplier personnel. This approach

can work with the simpler requests but given the likely complexity of the information and contracts, face to face interviews will be far more efficient in obtaining due diligence comfort on complex and material points. We would ask that Ofgem considers a limited number of joint workshops (or electronic meetings) to enable this dialogue which will lead to higher quality bids.

- 5.60 Would Ofgem please clarify how the reserve bidder can recover its costs from when the bid was submitted to it being released from this obligation? This is particularly important in relation to having committed finance on standby, which could be a significant cost.
- 5.66 An auction process is appropriate for a sale of a known asset without modification or bundled services and where the only material consideration is price. Ofgem recognises the need for non financial criteria to be considered as part of the tender and this will heavily compromise the operation of an auction.

Chapter 6

- 6.8 Ofgem will require the design and build contracts to be part of an Enduring tender submission. We remain concerned that there is a conflict between the considerable time required for OFTOs to engage with the supply chain to negotiate these contracts and the maintenance of the EU Procurement rules.
- 6.11 We continue to believe that the considerable benefits of a stronger and more coordinated approach to the Enduring regime are being overshadowed by the current process.

Appendices 21/09b

Appendix 7

- 1.3 Can you please provide an early indication on the timeline allowed for the prospective OFTO to prepare and respond to the ITT?
- 1.4 At the PQ stage the prospective OFTO must identify the specific projects they wish to bid for. We suggest that this project list should be seen as indicative, recognising that they will not have seen the IM at this stage.
- 1.12 Ofgem would obtain better protection if it was able to test whether the prospective OFTOs are able not only to secure the amount of finance, but also finance for the long term.
- 1.23 At the QTT stage prospective OFTOs are required to submit a quantitative cost assumption and desired project IRR without access to the data room. In the absence of the real data, knowledge of risks, assessment of the developer's O&M proposal and a detailed insurance assessment this analysis would need to be heavily caveated. Any weighting of this element should therefore recognise this considerable uncertainty.
- 1.35 Four months may be insufficient to obtain the firm insurance quote (given that everyone will be learning from this first OFTO experience).
- 1.36 Earlier in the documents Ofgem states that construction risk remains with the developer for the transitional phase. To this end the OFTO would expect to have no responsibility for carrying out the commissioning or correcting any issues that stem from faulty construction. OFTO involvement should be limited to having full observer access and then monitoring the commissioning performance in line with the SPA. With regard to failure rectification strategies can Ofgem please clarify what is an acceptable strategy for an emergency marine cable repair? At present there are few marine cable repair assets available and the reply on this key risk is likely to be limited.

Other

Can Ofgem clarify who will own the IP for the sea bed survey data for the export cable route?

Can Ofgem confirm where the physical boundaries are on the assets between TO, OFTO and developer?