

By email
Offshore Transmission Final Consultation
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Offshore Electricity Transmission – A further Joint Ofgem/DECC Regulatory Policy Update, Centrica's response

Dear DECC,

Thank you for the opportunity to respond to the Offshore Electricity Transmission further Joint Ofgem/DECC Regulatory Policy Update. This non-confidential response is on behalf of the Centrica group of companies excluding Centrica Storage Ltd.

Centrica notes that the code of practice in Appendix 1 of the consultation suggests that written consultations should normally last at least 12 weeks. We are disappointed that such a shortened timescale was allowed given the magnitude of the document.

With Go-Active imminent, Centrica is committed to assisting the implementation of the Offshore regime. Centrica welcomes the additional clarifications provided in the latest consultation however, there remain areas where we have concerns and these are detailed below.

The scale of the required investment in offshore windfarms means that certainty and stability are essential. Centrica needs to be assured that:

- A competent, efficient, cost-effective and consistently high performing OFTO will be appointed for projects the developer wishes to progress;
- The process of appointing an OFTO will not result in overall delays for commissioning;
- Construction and required repairs will be completed such that no generator asset is stranded (that downtime is minimised, and wherever possible agreed in advance); and
- Any transfer or revocation of OFTO licence does not result in the stranding of generator assets.

Given that the regime is not yet finalised and therefore not proven, it is not clear that the current design will deliver these requirements adequately. The initial tender rounds are

crucial and Centrica supports ongoing review of the regime by Ofgem and DECC. However, it is not clear what the success indicators of the regime are or how they will be measured and targeted. For example, would this be down to the number of bidders coming forward, some measure of the Ofgem/DECC envisaged efficiency savings, or by driving down supplier chain costs?

The regime design and proven workability will ultimately impact generator investment decisions. However, investment decisions in offshore wind are also impacted by many other areas. Whilst we support the recent increase in the ROC values, it is worth noting the following developments in relation to offshore wind that have either occurred or are in the change process that impact the viability of investment:

- The approved charging methodology proposal for TNUoS. This change in methodology from socialisation of costs to targeting has increased costs for offshore generation. It also includes an unfair charge for offshore generators who connect to distribution networks as these will now be charged wider TNUoS yet they do not use the wider transmission network.
- Transmission Access Review (TAR). TAR decisions may fundamentally change existing transmission access rights and charging. This uncertainty on connection arrangements for all transmission users, including offshore, increases the regulatory risk associated with offshore developments.
- BSC Transmission losses modification. The potential targeting of transmission losses onto the generators in zones furthest from demand will increase the costs for offshore wind generation.
- BSC metering requirements and BM unit configuration based on the definition of the transmission boundary point. Whilst we realise that the BSC is looking to addressing the issues identified, there could be cost implications for offshore generation based on the solutions of any modifications. Centrica raised this issue in the response to the November 2008 and believes that this should have been addressed as part of the implementation of the regime and not left to normal BSC change procedures.
- The asymmetric nature of risk. We remain unconvinced that it is appropriate for the generator to effectively take the bulk of the risk of transmission failure offshore. Whilst this risk is *apportioned* in the same way as onshore, there are fundamental differences in the offshore environment (such as being able to effect repairs) that mean the *effects* of such a risk allocation may be very different in the ways it might impact investment decisions.
- Owing to the current economic climate and the increasing reliance that is being placed on investment partners for planned and existing offshore wind projects, the OFTO regime needs to instil confidence in potential finance partners, i.e. economic viability of OFTO and deliverability.

In aggregation, these elements do, or (for those within the change process) would, make the economics of offshore wind less favourable when compared to other forms of generation.

Chapter 4 – Background and Policy context

Strategic Investment

Ofgem are developing proposals for an enhanced investment incentive scheme to allow TOs to invest in anticipatory transmission infrastructure sooner. Centrica supports the vision set out under the ENSG “Our Electricity Transmission Network: A Vision for 2020” report and encourage the use of this report as the blueprint against which to assess the associated risk of any TO specific investment proposals. It is important to note that the ENSG work concluded that there is significant amount of low regret anticipatory transmission investment required for the UK to meet its 2020 targets. Centrica supports the principle of appropriate rewarding of risk and this should be reflected in any reward or incentive scheme.

Supply Chain and Skills

Centrica welcomes the acknowledgement of potential supply chain skills as a key issue. However, as a customer of the supply chain, it is not clear how the OFTOs should be made to be responsible for the supply chain’s skills and expertise. There needs to be a broader responsibility, potentially government led, to ensure that attention is not just drawn to the issue, but plans are put in place to address it. The issue is not unique to the (offshore) supply chain, and the wider industry is expected to have a skills shortage going forward. OFTOs should only be responsible for putting in place plans for maintaining OFTO-related skills. Requiring OFTOs to actively participate in procuring ongoing supply chain skills would only be likely to increase the cost of bids.

We support Ofgem giving full consideration to whether an OFTO has the appropriate skills necessary to discharge their licence obligations. OFTO’s should have succession planning within their own organisation to ensure that they remain competent.

Chapter 6 – The Regulatory Proposals

20 year revenue stream

Centrica has consistently provided our view that the 20 year revenue stream is too short. It is our understanding that The Crown Estate is looking to increase the terms of the existing Round 1 and 2 leases to, in most cases, a substantially longer period (up to 50 years). With the life of most turbines expected to be at least 25 years, this presents a disparity between the offshore regime and generator leases. It would be inefficient if the vast majority of projects had to go through a reappointment of the OFTO or a re-tender exercise at the end of the revenue stream. Consideration should be given to extending the period for the revenue stream to at least the length of the turbine life. This would reduce the potential cost of requiring a re-tender at the end of the revenue stream where the generator would be likely to have to pay a portion of the costs whilst securing the whole tender.

Additionally, if most revenue streams were to be extended based only on O&M, then the availability incentive (at only 10% of revenue) for that extension would become negligible compared to the cost of major repair. This would not provide sufficient incentive for timely OFTO repairs.

Full indexation to RPI

Centrica disagrees that there should be full indexation to RPI. Ofgem/DECC have provided no clear reasoning for choosing full indexation despite making arguments for partial indexation in the November 2008 consultation. The rationale needs to be shared with the wider industry.

We believe that only the operational expenditure component of the revenue stream should be linked to RPI with other exposures being compensated by re-openers on a case-by-case basis. Were full indexation to occur, customers would ultimately bear the full risk.

Centrica asks for clarification that the indexation to RPI would also incorporate deflation.

Revocation of OFTO licence

Centrica supports the ability for the Authority to revoke an OFTO licence in the circumstances given providing that there is a process to ensure there is always a licensed OFTO in place to allow the transmission of the generator's electricity to shore.

Delivery Incentive

As Centrica has previously stated, a fundamental requirement of this regime will be the alignment and co-ordination of the various construction elements i.e. construction of offshore wind farm assets, onshore transmission assets, and OFTO assets. In order to avoid generators being over exposed to costs and/or securities this needs to be adequately addressed. The penalties for late delivery by the OFTO need to be significant and reflective of the exposures of other parties such as the wind farm operator. Assuming simple commercial incentives on the OFTO to deliver the capacity is insufficient. Additionally, the liquidated damages are capped at an amount that would cover only a fraction of the generator losses. Centrica believes an adequate penalty and incentive need to be applied.

The volatile and harsh conditions offshore mean that an offshore station requires back-feed from the grid to ensure that wind farm turbine components remain operable and do not sustain considerable damage. The developer would be taking a significant risk to build turbines if there are no guarantees that the OFTO will deliver on time and / or cannot rely on reasonable liquidated damages in the event of any delays. Therefore, developers will need to delay building the turbines until it is clear that the OFTO will deliver. This impacts the timeliness of the ultimate commissioning of the windfarm. Centrica continues to believe that the OFTO should face a more significant delivery incentive.

End of the revenue stream

Ofgem/DECC wish to retain flexibility to determine a sensible course of action at the end of a revenue stream. Whilst Centrica acknowledges that it would not make sense to make any commitments to actions 20 years ahead, it would be useful to understand what might be considered based on what would be given consideration now if it was the end of the revenue stream. For example:

- What would be included in the ongoing revenue stream?
- Would the priority be to ensure that the generator is not left stranded?

- Would the required duration of the extended revenue stream be considered when deciding whether to re-tender?

Known Unknowns

Centrica prefers the certainty of a 50:50 sharing mechanism of OFTO **refinancing gains** rather than Ofgem considering the merits of a mechanism at the beginning of each tender round. Ofgem/DECC's proposal could lead to inconsistent treatment by having different mechanisms in different tenders rounds.

Centrica does not believe that the offshore regime can, at this stage, be considered a purely efficient market, and it cannot be expected therefore that OFTO bidders will factor all potential refinancing gains into their bids as suggested in the consultation. The assumption that bidders will have full and perfect information on future refinancing, at the time they make their bids is not reasonable.

Centrica does not support a revenue uplift where an OFTO utilises assets more intensively to provide **incremental capacity**. As the generator would have set out its capacity requirements at the outset, this would only be appropriate where the generator explicitly requires additional capacity and this is obtained from more intensive utilisation. Otherwise the generator is paying for additional capacity it does not need.

Additionally, Centrica notes that it is stated on page 6 that incremental capacity will be generator led but this is not detailed elsewhere in the consultation. We do not necessarily believe that this has to be generator led, but should require generator approval.

It is not clear if additional **decommissioning** costs of the transmission assets, arising during the OFTO ownership of the assets, will be passed through on to the consumer, (via the GBSO/TOs) or the generator directly. We do not believe it is appropriate for the generator to bear this risk because, if in the future the Secretary of State amends the decommissioning requirements, generators will be similarly impacted with its own offshore generating and array assets and yet will not have the option to pass on the costs. Consideration should be given to the appropriate treatment of changes to decommissioning costs for both generators and transmission owners.

The transmission assets are owned by the OFTOs and therefore it would seem inappropriate for the generator to bear this risk. However, if the regime will place this risk on the generators either via a direct pass through or the potentially less efficient route of OFTOs frontloading any expected cost in their bid, then Centrica prefers the GBSO pass-through mechanism as the least worst option. For consistency, in the unlikely event that any savings occur due to relaxed Secretary of State decommissioning requirements, then it should be clear that the savings are passed to the generator who has already paid these costs through TNUoS. Additionally, when Ofgem is evaluating bids the decommissioning costs need to be itemised; and where these decommissioning costs vary from bid to bid, Ofgem needs to ensure that having these costs, as a pass-through item, are not a means to present a cheaper tender price.

There should also be symmetry of any pass through costs in relation to changes to the STC such that any savings are also passed through.

Excluded Services

For an OFTO to be able to carry out certain activities outside their price control, it is essential that undertaking these activities does not detrimentally impact the regulated services to the generator. Centrica acknowledges that there might be overall benefits where an OFTO has underutilised resources at certain times of the year and could expedite repairs for other OFTOs. However, there needs to be clear prioritisation of this resource to the generator. Therefore any work being undertaken by the OFTO on behalf of another OFTO would have to cease were that resource needed for the OFTO's primary customer – the generator for which it holds the OFTO licence.

Additionally, please clarify whether it is intended that this would also be limited to the 2.5% of allowed revenue, consistent with onshore.

Performance Incentive

Centrica continues to believe that the 10% limit of OFTO revenue at risk is insufficient to cover the cost of a major outage, even with the accumulation of debits. Therefore the generator is essentially taking a significant portion of the transmission risk.

Whilst disagreeing with the limited OFTO risk proposed, Centrica provided a detailed response to the OFTO availability incentive strawman in the November 2008 consultation and would like to thank Ofgem/DECC for the engagement and consideration this was given. Centrica also supports the concept of a performance bond to ensure performance incentive toward the end of the revenue stream.

Centrica does not support the banking mechanism which allows for the accumulation of credits such that an OFTO could reduce its target in years subsequent to good performance. Centrica believes that it is perverse that performing well in one year should allow for poor performance in future years.

Whilst the default regime will still be the strawman proposed in the November consultation, Centrica welcomes the additional flexibility that the proposals now allow. It would be useful to clarify to what extent this flexibility extends to vary from the default targets.

To what extent would the flexibility allow for:

- A regime where availability targets did not decrease?
- Planned outages to be excluded from the incentive?
- Targets to vary according to the season?
- Indexing targets to ensure they are stronger when prices are higher?

Centrica also believes that it would be sensible for generator and OFTO outages to be coordinated wherever possible, and it should be ensured that the availability incentive accommodates this.

Additionally, please clarify that the availability incentive is calculated on an individual project basis. An OFTO should not have the ability to average its performance over all or several of its projects.

Continued poor performance

Centrica supports the ability of Ofgem to be able to revoke the licence of a consistently poorly performing OFTO on a case-by-case basis. Centrica notes that the criteria for what constitutes poor performance should depend on the generator requirements and there should be the ability for the generator to start the process, potentially via a request for Ofgem to consider revocation. As Centrica has often emphasised, it is critical that a generator is never left stranded. It therefore needs to be clear that any revocation of an OFTO licence cannot occur unless alternative arrangements have been secured for the developer's assets to be able to legally transport the power to shore. The affected generator should be able to provide input into the selection of the new OFTO appointment.

Paragraph 6.68 (the first paragraph 6.68) states that the circumstances in which the Authority would consider revoking a licence would be clearly set out ex-ante. We look forward to seeing these. When will they be published?

Tender Process

We provided a full response to the competitive tender consultation on 16 April 2009.

Our main concerns are:

- There should be generator involvement in the selection of the OFTO;
- There should not be a requirement to guarantee construction completion within 12 months of OFTO award under the transitional regime;
- Under the enduring regime, it appears that both the early and late appointment of an OFTO has potential detrimental impacts;
- The Independent Audit Report should vary depending on whether assets are built and operational or not;
- It is not clear how an auctions process would work and this should not be considered at this stage;
- Elements of pre-qualification do not need to wait until the tender process starts;
- Added clarity is required for when developer security should be returned and when it would be forfeited; and
- Ofgem needs to ensure that it formally requests confidential information in order for this to be provided.

Developer involvement in the appointment of an OFTO

As stated in our previous response, Centrica considers it is critical that, where the developer is not part of an OFTO bid, it is actively involved in the OFTO selection and that Ofgem provide a structured process by which this can occur. Centrica would support Ofgem giving developers sight of the bidders invited to tender and their resulting bids such that the developer can provide valuable advisory input in the selection of the preferred bidder. This should also extend to the process of OFTO of last resort.

Where the developer does not support the selection of the preferred bidder there would be benefit in having some means by which to appeal to Ofgem in certain defined circumstances. This could avoid situations arising where an OFTO has been appointed but the developer does not wish to accept the amended connection agreement, resulting in potentially costly legal resolutions. An appeal could for example, be allowed in such circumstances where the developer can provide evidence that the selected bidder is not

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appropriate. The generator and OFTO will be forced into a long-term relationship and it is essential that good working relations can be developed.

OFTO of Last Resort

As a developer Centrica continues to believe that it is essential that there is an OFTO of last resort mechanism in the enduring regime.

Offshore wind is a key part of meeting the UK's renewable energy targets. Transmission is a critical part of the process to achieving offshore wind generation, therefore it would seem perverse that offshore wind plans of the generator in the enduring regime might not be able to progress because no OFTO comes forward. The necessity for ROCs for generation already acknowledges that the economics for offshore wind are marginal and need to be improved. Relying on the market seeing an economic case for investment in transmission would not appear to be consistent. This, along with asking developers to progress plans and invest significant resource into offshore wind projects for which an OFTO might not come forward does not appear to facilitate meeting the renewable energy targets.

Chapter 7 – Standard industry framework

BSC

Centrica outlined as early as our 18 December 2008 response (and expanded on this in our 9 January 2009 response) that the offshore regime results in an undesirable and inefficient BM Unit configuration. We highlighted that consequential changes to Section K of the BSC should be considered. The issues are clearly outlined in the Imbalance Settlement Group papers for the 24 April 2009 meeting (meeting 99).

It is disappointing that the issue appears to be being dealt with under normal BSC governance when it could be resolved as part of the implementation of the offshore regime. We are aware that the BSC Panel is likely to raise a BSC Issue to look into this area with a view to providing potential modifications; and whilst the BSC Processes are robust, the lack of clarity simply introduces another, unnecessary, element of uncertainty. In addition, the BSC process is not guaranteed to provide the required solution by Go Live when the issue will manifest itself.

Transmission Licence Standard Conditions

Centrica believes that these are broadly sensible. We have the following comments:

- A robust implementation of the appointment and the role of the compliance officer as well as the separation of businesses are key.
- The conditions require publication of the monitoring reports. These should be clear and not so high level as to reduce the value;
- In paragraph 10 and 11 of new condition B18 (and paragraph 10 of new condition E21), it would appear that the paragraph reference should be to paragraph 7 and not 6;

- We note that under paragraph 12e of condition B18, this varies from Supplier of Last Resort (SoLR) in that under SoLR, the SoLR is encouraged not to reclaim the costs if they want the customers;
- It is not clear what paragraph 6e of new condition C8 is achieving;

OFTO Special Licence Conditions

It is not clear why there is such a big difference between the OFTO special conditions and existing conditions in relation to the percentage for which regulated transmission revenue can exceed the allowed transmission owner revenue. In new condition C5, paragraph 1, the regulated transmission revenue can exceed the allowed transmission owner revenue by 10% (with a figure of 15% used in paragraph 2 for two successive years). It is our understanding that this compares to 3% and 4% respectively for existing conditions.

Other areas

The DECC Impact Assessment

Centrica considers that there is a significant risk of overstatement of net benefit (£925 million) in the Impact Assessment. The majority of the benefit appears to arise from estimated efficiency savings due to the tender process of 10-20% equating to £1.08bn to £2.36bn. We are not persuaded by the counterfactual, as we believe that if developers were building their own assets, they would still undertake robust commercial tender exercises which, given they are part of wider contracts, in many cases might be more rather than less effective at securing savings than the regulated tender process proposed. Therefore it is not clear how a blanket saving of 10-20% due to the competitive OFTO tender regime can be applied to the entire expected cost of the assets. For the Impact Assessment to have credibility there needs to be further detail and firm evidence regarding the 10-20% efficiency savings assumption.

Given the primary cost differentiator is financing, this Impact Assessment implies that OFTOs can achieve significantly more favourable financing than a developer. It suggests OFTOs can significantly reduce the financing and operational costs over the 20 years, even after front loading any additional risks that may materialise given there are no price re-openers, and the inability to leverage the resource synergies for maintaining both the transmission assets and the cable arrays.

Additionally, DECC indicates that the efficiencies will be measurable, but it is not clear what will be measured. For example, it is not apparent how the regime will actually drive down supplier costs which continue to rise. There are only two credible suppliers at this moment so it is not clear that an OFTO regime would drive down costs any more than not having the regime in place.

Charging

Centrica remains concerned that the charging regime will have a negative impact on the viability of existing and future projects.

Centrica raised some concerns in our 9 January 2009 response to the November consultation and also to National Grid's consultation on modification GB ECM-08 in November 2008 which do not appear to have been addressed.

Our concern is in relation to an offshore connection to a distribution network. As stated in our response to GB ECM-08, we are comfortable with the DNO cost pass-through element, and with the TNUoS charges relating to the OFTO assets (local and circuit). However, we consider that the levying of the 'wider' and 'residual' elements of the TNUoS charge on such generators is wholly inappropriate - the rationale for them currently not paying TNUoS is that they are not making use of the wider transmission network, and that will not change in any way.

There needs to be changes to the current charging methodology to correct this inconsistency.

Offshore Implementation Plan

Centrica welcomes the plan and the clarity it gives to the implementation process.

Finally, Centrica would like to reiterate our thanks to Ofgem, DECC and all other parties contributing to the policy update.

If you have any questions or comments relating to this response, please contact me on the number above or at chris.stewart@centrica.com

Yours sincerely

By e-mail

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