



Overview of Great Britain's Offshore Electricity Transmission Regulatory Regime

JOINT DECC/OFGEM STATEMENT

Annexes

17 June 2009

URN 09D/612

Ofgem ref: 67/09

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Published by the Department of Energy and Climate Change

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Annex 1. What Has Changed Since the March 2009 Final Consultation?

This section highlights two areas where we have updated our policy for regulating offshore electricity transmission following the consultation on the March 2009 Government Response. The summary of the contributions to that consultation, and our response, is in a second annex which follows this one.

The main changes to our policy are in relation to the issue of ensuring that we have the right skills and supply chain going forward to deliver on our 2020 targets and on the OFTO of Last Resort policy, both of which were the subject of questions in the final consultation.

1. Skills and Supply Chain

In the March 2009 Consultation, we flagged this as an ongoing issue which would be considered both before and after 'Go-Active'.

In evaluating bidders for tenders Ofgem will be assessing their technical capabilities to successfully deliver that project; this will include being satisfied that they have the requisite skills and supply chain arrangements in place. In addition we will continue to work with stakeholders to ensure that the skills and supply chain are in place to enable the electricity industry to meet the future demands made on it both onshore and offshore.

2. OFTO of Last Resort

Background

The Government and Ofgem have been consulting on and refining our proposals for an OFTO of Last Resort mechanism since July 2007. Broadly, the proposal has been that, in the unlikely event that two rounds of tenders for a transitional project fail to identify a suitable OFTO, an OFTO of Last Resort will be appointed to prevent stranding of the generation assets.

This policy has been refined through subsequent consultations to take into account the unbundling requirements of the EU Third Package and to provide safeguards so that, for example, an OFTO of Last Resort is not required to take on assets which then adversely impact on its ability to conduct its existing business. We have also broadened the scope of the policy, following

consultation, to include abandonment by OFTOs either during or post-construction.

Updated Position in the March 2009 Government Response

The position developed for the March 2009 consultation included a number of safeguards for potential OFTOs of Last Resort.

Furthermore, we consulted on a set of criteria which the Authority would use to select an OFTO of Last Resort from several potential candidates.

We also proposed that:

- The Authority would hold a review of the direction within five years or if there had been a material change in circumstances;
- The Authority would consider directing an OFTO to become OFTO of Last Resort before an onshore TO, unless there were exceptional circumstances;
- The Authority would seek to appoint an OFTO of Last Resort by consent, where possible; and
- The Government and Ofgem intended there to be a right of appeal and would consider what the mechanism would be.

Developments since Publication of the March 2009 Government Response

In response to the March consultation document, eleven respondents provided comments. These were generally supportive of the OFTO of Last Resort mechanism and welcomed the greater clarity on the process, although some requested further detail.

We are now able to provide further details of how the policy will work in practice. These are now reflected in licence conditions B18 and E21 in the standard licence conditions published alongside this Statement and Annexes on the DECC and Ofgem websites.

Criteria

In the last consultation we invited views on potential criteria which the Authority would use to select an OFTO of Last Resort. We have since refined our proposals to clarify the information which could be considered in reaching a decision. The Authority will take into account financial, operational and technical standing along with any information provided in relation to expected

costs, cost effectiveness and, where appropriate, the period for completion of construction. The Authority will also take into account any other relevant information available which may include the quality, price, technical merit, functional characteristics, environmental characteristics and location of the relevant transmission assets.

Revenue Stream

Our proposals for an offshore transmission regulatory regime anticipate that successful OFTOs will be granted a 20 year revenue stream with no further regulation of the price control. Clearly, in an OFTO of Last Resort situation, a different approach will be needed as the competition will have identified neither an OFTO nor a revenue stream for the assets. Consequently, the Authority will need to set the revenue stream in discussion with the OFTO of Last Resort. This will take place using the established procedures outlined in section 11 of the Electricity Act which are used to set the onshore price control. As these price controls are reviewed at least every five years, a direction will be set for a period not exceeding five years.

Safeguards

We have clarified that licensees will only be directed to become an OFTO of Last Resort if they can comply with the direction without materially prejudicing their other contractual obligations; operate the assets in an economic and efficient manner; finance the activities; and that they will receive a reasonable rate of return.

Furthermore, an OFTO of Last Resort will be able to make representations to the Authority to reconsider a direction before it is made. The OFTO of Last Resort will also be able to request a review at any time when there has been a material prejudicial change to their circumstances. We think that this right of review, combined with the consensual setting of the revenue stream strike the right balance for protecting an OFTO of Last Resort – an issue identified in the March 2009 Government Response.

If the OFTO of Last Resort remains unhappy with the arrangements, and another party is found which would be willing to take on the assets or one which is better placed to carry out the functions of the OFTO of Last Resort the direction will be revoked.

We think that this combination of measures meets stakeholders' needs for greater certainty on how an OFTO of Last Resort would be chosen and how the policy would operate in practice.

Next Steps

Licence conditions obliging transmission licensees to act as OFTO of Last Resort in certain circumstances will be part of the transmission licence. The Secretary of State will make changes to existing transmission licences to insert the OFTO of Last Resort conditions. These changes will take effect at 'Go-Active'.

Ofgem will shortly consult on guidance notes for the OFTO of Last Resort mechanism.

Annex 2. March Consultation – Question by Question Analysis

This Annex provides details of responses received to the March 2009 final consultation document. It follows the same structure as the questions asked in that document. We have also included comments made by respondents not in direct response to a question. We have not included comments made which repeat comments made in response to previous consultations as these views have already been considered. This appendix also contains (in bold) our response to points made, where appropriate, or cross-references to where the issue is covered elsewhere.

The March 2009 final consultation document asked a number of specific questions, replicated in this summary, about supply chain/skills capacity; the design of aspects of the regulatory regime; OFTO special licence conditions; the Offshore Transmission Implementation Plan; and proposed modifications to codes and licences. Nominations for OFTO representatives for the Grid Code Review Panel and STC Committee were also invited.

There were 18 written responses to the consultation document from developers, existing TOs, GBSO, potential OFTOs and investors, and environmental NGOs. The responses contained a number of constructive suggestions and looked forward to the establishment of the new regime. There were a number of requests for clarification and suggestions for improvements to the regime and the drafting of the codes and licences. The non-confidential responses may be viewed on the Ofgem website.

Responses to Specific Questions

Question 1: We would welcome respondents' views on the supply chain and skills capacity. In particular, we would welcome views on the extent to which Ofgem, when granting OFTO licences, should take into consideration the policies and processes proposed by each bidder for developing and maintaining the appropriate skills necessary for them to discharge their licence obligations.

Thirteen Respondents provided comments on this question. All recognised the importance of the issue and the vast majority highlighted the importance of skills and supply chain being fully considered in the tender process to ensure that a bidder would be able to discharge its licence obligations for that project. Two respondents felt this issue was of more relevance to tenders in the enduring regime and one considered it more important for OFTOs connecting more than one project. One respondent felt that requiring new entrants to demonstrate skills and supply chain capabilities beyond those required to discharge licence obligations for the particular project it was bidding for would be too onerous, at least in the first few tender rounds. Some respondents

expressed a willingness to work with Government, Ofgem and industry in tackling the long term skills and supply chain issues for example through the Electricity Networks Strategy Group (ENSG).

In evaluating bidders for tenders Ofgem will be assessing their technical capabilities to successfully deliver that project; this will include being satisfied that they have the requisite skills and supply chain arrangements in place. In addition we will continue to work with stakeholders to ensure that the skills and supply chain are in place to enable the electricity network to meet the future demands made on it both onshore and offshore.

Question 2a: We would welcome any further views on our approach to dealing with predefined adjustments for 'known unknowns'.

Twelve respondents commented on our approach to 'known unknowns'. There was general support for our overall approach but comments were made on the approach to individual 'known unknowns'.

Refinancing

Five respondents provided comments. All agreed with our proposal that the approach to refinancing should be clearly set out before the start of each tender exercise. One respondent felt there should be no clawback mechanism for refinancing gains as it would distort competition. Two respondents advocated an *ex ante* 50:50 or symmetrical sharing mechanism to be introduced for all tenders to provide certainty to bidders. One respondent felt that OFTOs should be the primary beneficiary of any refinancing gains.

Having considered these final responses we are of the view that our final position should remain as set out in the final consultation. As such any decision by the Authority to apply a refinancing mechanism to enduring projects would be decided *ex ante* on a case-by-case basis and with due regard to prevailing market conditions. This will not apply to transitional projects.

Decommissioning Cost

Six respondents commented on our proposed conditional pass-through of any additional OFTO decommissioning costs. Three respondents explicitly supported the approach. One respondent felt an automatic pass-through more appropriate while another expressed concerns that OFTOs might attempt to pass through inflated costs. One respondent asked whether the additional costs would be passed on to the generator or the consumer (via the GBSO/TOs). Two respondents suggested that any reduced decommissioning costs for the OFTO should be "passed back" to the generator. One respondent requested clarification of "conditional".

Having considered these final responses we are of the view that our final position should remain as set out in the final consultation. Decommissioning costs will be subject to a conditional pass-through mechanism. This means that they will only be allowed once the Authority is satisfied that the costs are reasonable and efficient. This mechanism will be symmetrical and so would also apply to any reduced decommissioning obligations on the OFTO. These costs will be added to (or subtracted from) the OFTO revenue stream and recovered through transmission charges (as per NGET's charging methodology).

Incremental Capacity

Five respondents commented on this issue. Three were supportive of the proposals. One respondent did not support a revenue uplift where an OFTO utilises assets more intensively to provide incremental capacity. One respondent felt such incremental capacity increases should include GBSO-led changes. One respondent argued that OFTOs should be allowed to bid on the basis of anticipatory investment to accommodate future generation.

Having considered these final responses we are of the view that our final position should remain as set out in the final consultation. OFTOs will only be able to bid on the basis of the capacity level required by the tender process (i.e. as defined by the generator(s)).

Question 2b: We would welcome any further views on the OFTO of last resort proposals.

Eleven respondents provided views on these proposals. They supported an OFTO of Last Resort mechanism and welcomed the greater clarity surrounding the OFTO of last resort process, although some required greater detail.

One respondent advocated OFTOs being able to express a wish not to be considered as a potential OFTO of last resort if they did not wish to be. One respondent called for generator involvement in the OFTO of last resort appointment process and a right to appeal any decision to appoint.

The obligation to become an OFTO of Last Resort will be placed on all transmission licensees (onshore and offshore) and the criteria for selection as an OFTO of last resort will be set out in standard conditions (slightly different conditions apply to onshore and offshore transmission licensees) of the transmission licence. Furthermore, Ofgem are currently completing a set of draft guidance notes on the OFTO of Last Resort selection process, which will be published for consultation and finalised prior to commencement of the first tender round. Further detail on the OFTO of Last Resort is at Annex 1.

Question 2c: We would welcome any further views on (our proposed) business separation requirements.

Five respondents commented on this issue. They broadly supported our proposed enhanced business separation requirements from NGET and industry more widely. Two respondents advocated more stringent requirements.

Ofgem published a consultation on NGET business separation special licence conditions on 17 April. The consultation closed on 16 May. NGET has accepted the proposed Special Conditions (C1-C3 of its transmission licence). Ofgem will shortly issue a modification to implement these changes.

Question 3: Ofgem would welcome respondents' comments on the entirety of the legal text attached at Annex 11, which reflects the policy set out in chapter 6. In particular Ofgem would welcome comments on:

- ***Whether the licence text in this annex accurately reflects the policy proposals presented in the main body of the document.***
- ***Whether the licence conditions provide sufficient certainty from a commercial perspective.***
- ***Any aspects of the drafting to which respondents consider changes or clarification would be welcome to improve certainty for investors or developers.***

Respondents' comments suggested that the drafting in the Annex did reflect the policy positions in the main body of the document. Respondents also noted a number of minor errors in the syntax of the drafting.

Ofgem appreciate the useful comments provided by respondents in relation to the drafting of the special licence conditions. Individual drafting mistakes will be considered and rectified. Respondents should also note that Ofgem have employed the Brattle Group to carry out a full audit of the Special Licence Conditions relating to the OFTOs revenues entitlements including the performance incentive and adjustment mechanism. Ofgem believe it appropriate to have a third party review the conditions to ensure that they are robust and properly reflect our policy positions.

Question 4: We would welcome comments on the activities identified in the Offshore Implementation Plan and feedback on any activities that should be undertaken in the Implementation Period that are not included in the Offshore Implementation Plan.

Three respondents felt the plan represented a good start in setting out the issues. They all looked forward to seeing further detail and working with Ofgem, where appropriate, in delivering the plan.

Question 5: We would also welcome nominations for representatives for the Grid Code Review Panel (GCRP) and the System Operator Transmission Owner Code (STC) Committee from prospective OFTOs. Please note that representatives do not have to be an OFTO, provided the nomination is supported by OFTOs. Nominations should be sent to the Secretary, whose contact details can be found on the relevant Committee pages on NGET's website.

Two respondents recognised the need for representation on the GCRP and STC Committee and expected that nominations for representatives would be made in the future.

Question 6: We propose that the Secretary of State makes the changes set out in the annexes to this consultation, subject to evidence to the contrary. We would welcome respondents' views.

The majority of respondents were in support of the proposed changes to the relevant documents being made by the Secretary of State under the powers in section 90 and 91 of the Energy Act 2004.

One respondent wished to see a fundamental review of the proposal before any changes to the relevant documents were made.

We have consulted extensively in respect of the changes proposed to the relevant documents. We also recognise that the relevant documents are not static documents and are subject to review and change under normal governance arrangements. We have considered all changes made under normal governance arrangements that have been implemented during the development of our offshore transmission change proposals. Where we considered that different treatment was required offshore, we have developed the necessary change proposals which have been included in the changes that the Secretary of State was asked to implement.

Comments Made not in Response to Specific Questions in the March 2009 Consultation Document

Strategic/coordinated investment in offshore grid

Many respondents highlighted the importance of strategic/coordinated investment in developing the offshore grid. Four respondents felt the new regime would deliver the necessary offshore transmission infrastructure and one welcomed steps taken to enhance coordination between onshore and offshore transmission. One respondent felt that the proposed regime, by itself, would not deliver coordinated development of an offshore grid. One respondent advocated GBSO developing a strategic plan for the development of offshore networks. One respondent thought that coordinated development would minimise the environmental impacts of cable laying.

One respondent supported the extension of work on anticipatory investments to the offshore regime. However, another felt that this ran the risk of stranded transmission assets causing unnecessary environmental impacts. Four respondents expressed a preference for exclusive zonal appointments in the enduring regime.

The March 2009 Government Response set out how we envisage co-ordinated network development taking place in Round 3. We have continued to examine this issue in the light of respondents' views and discussions with NGET and The Crown Estate. We remain confident that the regulatory regime we have devised has the necessary flexibility to deliver the network that is needed.

We recognise the need to develop a vision for the future network needs. The ENSG, in its March 2009 report "Our Electricity Transmission Network: A Vision for 2020", identified the network issues which the UK will face in achieving the 2020 renewables targets. We need to build on this vision so that all the parties involved have the kind of information they need to make investment decisions which lead to optimal network development.

Review/monitoring of regime

Four respondents advocated an early (or ongoing) review of the regime to ensure it was delivering the anticipated benefits and able to deliver Round 3 projects. One respondent suggested an independent evaluation of the new regime based on criteria set before 'Go-Active'. One respondent proposed that 'Go-Active' be delayed by 2 years to allow a review of the entire regulatory structure to take place.

We will monitor the new regime to ensure that it is delivering the anticipated benefits and remains compatible with Round 3 developments as more information becomes available. We believe that

the new regime is fit for purpose and do not believe that delaying ‘Go-Active’ is the right approach.

Third Package: Enhanced Ownership Unbundling Requirements

Six respondents commented on EU unbundling and its potential impact on the offshore transmission regime. Two respondents welcomed the clarity given in the March document. One respondent requested further information on derogations and the role of TO, SO and Transmission Operator. One respondent requested a clear statement from DECC and Ofgem that post implementation of the EU Third Package requirements generator affiliate ownership of any transmission assets will not be allowed. One respondent felt that generator affiliates should not be allowed to be OFTOs at all. Three respondents requested clarity on how a generator would divest itself of transmission assets. One respondent reiterated that changing the definition of offshore transmission to above 132kV for Rounds 1 and 2 projects would negate the need to comply with any unbundling requirements.

We welcome respondents’ comments that they are now clearer on how the 3rd Package requirements may impact on the offshore transmission regime. Bidders will be required to comply with the requirements of the 3rd Package when these are transposed into UK law. The Government will be consulting on its implementation of the 3rd Package. We should also reiterate that it is incumbent on any potential OFTOs to seek their own legal advice as to what form of business structure would be appropriate to ensure that its undertakings are sufficiently separate, so as not to breach UK law.

Regulatory Regime

Revenue Stream Indexation

Two respondents requested clarification on the treatment of the revenue stream if and when the RPI goes negative.

As indexation is primarily in place to protect the OFTO against future cost risk, we see no reason why the indexation should not have a symmetric benefit to the generator when costs are falling. This is consistent with our onshore approach. We can therefore clarify that negative RPI would be passed through in the same way as positive RPI.

Performance incentives/banking mechanism/performance bond

Four respondents requested clarification on the operation of performance incentives. One asked about the relationship between the performance incentive and the banking mechanism. One respondent felt that the 10% penalty would be insufficient incentive for any projects extended beyond the initial 20 year revenue period as the revenue stream would likely be based only on operation and maintenance. One respondent requested clarity that the

incentives would be on a project basis. One respondent asked whether the performance bond would reach 50% in the final year of the revenue stream. Respondents had detailed questions on the operation of the banking mechanism in the availability incentive and the performance bond.

We can clarify that performance incentives will be set on a project basis and that the performance bond will reach 50% in the final year of the revenue stream.

Delivery Incentive

Four respondents commented on the delivery incentive proposals. Two supported the delivery incentive on onshore TOs. One felt that the liquidated damages in the event that an OFTO fails to deliver on time should be higher. One felt they should be higher for onshore TOs. One respondent asked how long it would take to enforce a liquidated damages provision under the TOCA. One respondent asked at what rate GBSO would 'pay' liquidated damages to an OFTO in the event of late delivery by the onshore TO.

We are satisfied that the delivery incentives through the liquidated damages provisions will provide a sufficient incentive for all transmission licensees to deliver infrastructure required for user connections in accordance with the contractually agreed completion date. We have seen no persuasive evidence to suggest that the payment arrangements and the limitation of liability that apply between CUSC and STC parties in respect of offshore developments should be different to current onshore arrangements. We note that detailed arrangements relating to the liquidated damages provisions are contractually agreed between NGET and TO(s) as part of the TOCA(s) and also between NGET and the generator in the relevant CUSC bilateral construction agreement.

Construction Security

One respondent asked how the £5m liquidated damages cap in the event of abandonment had been calculated and whether it would be sufficient to recognise the potential loss for an offshore generator from late delivery.

The liquidated damages cap reflects onshore arrangements that apply to other types of transmission connected generators. We have seen no persuasive evidence of the need to a different cap for offshore generators.

Excluded Services

Two respondents requested clarity on whether the 2.5% of allowed revenue cap applied to all revenues earned by the OFTO outside of those granted under its licence.

There is no cap on excluded services, however there is a 2.5% cap on *de minimis* activities.

Tender Process

Four respondents advocated greater generator involvement in the tender process, eg giving them sight of bidders and bids. However, other respondents were concerned about generators potentially distorting the competitive process through a bidding generator affiliate, eg by withholding information from other bidders. Two respondents favoured prohibiting generators from becoming OFTOs and three emphasised the need for strong regulatory oversight in the absence of a prohibition. One respondent raised concerns about the impact of overly strict business separation requirements on the number of bidders in tender competitions and efficiency of bids by any generator affiliates.

Ofgem expects to publish a final document on the tender process shortly.

Charging

Two respondents raised concerns about the adverse impact of the approved new charging methodology on offshore generators.

We note that there was extensive consultation throughout the development of NGET's charging methodology modification proposals. We also note that the Authority carried out an Impact Assessment consultation to inform its decision on the charging methodology modification proposals submitted by NGET. The Authority decided not to veto NGET's proposed charging methodology¹.

Impact Assessment

Two respondents raised concerns about the assumptions used in the impact assessment accompanying the March consultation document and the resulting figures.

The impact assessment sets out the evidence base for our calculation of potential costs and benefits and we have accounted for possible uncertainties by presenting benefits and costs as a range. We have not seen any evidence in the responses to persuade us that this range is not robust.

Relevant documents

¹ The Authority's decision was issued on 30 March 2009 and is available from Ofgem's website at <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=93&refer=Networks/Trans/ElecTransPolicy/Charging>.

A number of respondents provided detailed comments on the proposed changes to the relevant documents set out in the annexes to the March 2009 Policy Update. We received a number of specific comments on the drafting of the standard conditions of the transmission licence, STC, Grid Code and SQSS.

We thank respondents for their input into the proposed changes. Many of the comments we received have been adopted and the drafting of our detailed change proposals amended accordingly. There were some specific comments which we have not been able to adopt because they were not consistent with our stated policy position and, after considering their merits, we came to the conclusion that they did not present a sufficiently persuasive case for change. Others we were unable to adopt because they related to existing obligations where review should be progressed under normal governance arrangements. In respect of such comments, we have not amended the drafting of our details change proposals.

A number of respondents raised issues relating to the extension of existing onshore obligations offshore.

In developing our change proposals, we decided that it was important to maintain consistency between onshore and offshore arrangements wherever possible. In some circumstances where respondents had commented that the current onshore arrangements needed review or amendment, we chose to replicate existing onshore arrangements offshore. We do not consider that it would be appropriate for the Secretary of State to make changes unless these are connected with offshore transmission and remain of the view that such matters are better progressed under normal governance arrangements. We note that some of this work has already begun, for example a review has been initiated under the BSC in respect multiple BM unit configurations and metering requirements at boundary points for large wind farms and the GBSQSS Fundamental Review has a specific offshore transmission workstream.

We are aware that generic requirements in codes provide certainty for industry participants however we also recognise that there can be limited (if any) value in defining generic requirements in the absence of adequate information or experience. Noting that we do not yet have sufficient experience of operating offshore transmission systems, our approach has been to define default generic requirements where possible and allow for alternative arrangements to be defined as part of a bilateral agreement on a project specific basis. We note that in the absence of a default requirement, arrangements would be specified in the relevant bilateral agreement(s).