

To all with an interest in offshore electricity transmission.

Promoting choice and value for all gas and electricity customers

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Dear Colleague,

Offshore Electricity Transmission: An Open Letter on the Enduring Regime

The Government commenced the new offshore transmission regulatory regime in June 2009, following an extensive consultation by Ofgem and DECC. Shortly afterwards Ofgem launched the first transitional¹ tender round, in which £1.1 billion worth of transmission connections to offshore wind farms are currently being tendered. This first transitional tender round to identify Offshore Transmission Owners (OFTO's) is up and running, and the first round of enduring² tenders is expected to commence in summer 2010.

Earlier this year, we consulted on the overall design features of our enduring tender process and regulatory incentives, and are now considering our detailed approach to implementing the tender process and regulatory regime for enduring tenders. As such, this letter sets out the detailed issues which we propose to consider further in deciding how the regulatory regime and tender process is applied by the Authority for the enduring tenders, and potentially also for the second and final transitional tender round.

It is our intention only to update the details of our previously stated approach where there is a demonstrable need for change to ensure the efficient operation of the enduring regime (i.e. our focus is on refinements rather than wholesale changes). Any updates will be within the framework set out in the Ofgem/DECC Statement on the form of the offshore regulatory framework published in June, relevant developments in onshore regulatory policy, and any subsequent amendments to Government policy in this area.

The purpose of this letter is to provide advance notice of our proposed consultation and to invite early views on these issues so as to inform our formal consultation which will be launched in mid December.

In summary, this letter:

- Sets the scope and timing of Ofgem's enduring tenders consultation process;
- Provides a brief background to the development of the overarching regulatory framework for Offshore Electricity Transmission;

¹ Transitional projects are those which are constructed or under construction by a windfarm developer prior to 'Go Live' (expected June 2010)

² Enduring projects are those where construction will commence after 'Go-Live' and OFTOs will undertake construction as well as operation, maintenance and financing

- Highlights a number of relevant developments which have been announced since “Go Active” which may have implications for the enduring tender process; and
- Explains the key themes that we propose to consult on in relation to the enduring tender processes - these include:
 - Early or late OFTO appointment,
 - Treatment of pre-construction costs and tender information,
 - Treatment of future capacity increases,
 - Risk Management, Refinancing and Incentives,
 - The Role of the NETSO,
 - Qualifying Project Pre-Conditions and Tender Entry Criteria,
 - Stages and Timing of the Tender Process,
 - Assessment of the Tender Process (including treatment of losses),
 - Supply Chain and Competition.

Enduring Tender Consultation – Roles and Scope

Role of Government and the Authority

The Government has taken the high level decisions on the regulation of offshore electricity transmission³ and made the changes to the regulatory regime it believes necessary for Ofgem to run the competitive licensing regime. Both Ofgem and DECC have previously acknowledged that amendments would need to be made to certain elements of the regime for enduring tender processes. Because of this, the regime was designed by Government to allow Ofgem to incorporate flexibility into the shape of future tender rounds. As such, responsibility for the ongoing operation of the regime now lies principally with Ofgem and industry. There are four key routes that may be used to update the rules of the offshore transmission regime in the future:

- The Authority may make changes to the tender regulations (such changes would need to be approved by the Secretary of State);
- The Authority may vary the Special Conditions in Offshore Transmission Licences;
- The Authority may propose changes to the NETSO’s licence; and
- The industry may make changes to the codes through normal industry governance arrangements.

Both the Government and Ofgem note that the Secretary of State has powers under sections 90 and 91 of the Energy Act 2004 to make modifications to the codes and licences in the 18 months following “Go Active”. However, neither DECC nor Ofgem currently anticipate that decisions made following the enduring tender consultation will be implemented through this route.

Scope

At the highest-level the consultation is concerned with ensuring that, within the framework established at ‘Go Active’, the arrangements for future offshore transmission tenders remain clear and transparent, promote the efficient and economic development of the offshore transmission networks and deliver value for present and future consumers. In our view, there are three key drivers for this consultation process:

- **Issues previously identified for consultation** - In the course of consulting on the detailed design of the regulatory framework and tender process to be applied to

³ And implemented these decisions through powers in the 2004 and 2008 Energy Acts.

transitional projects, Ofgem highlighted a limited number of issues which we acknowledged would need to be adapted or considered further in finalising the enduring regime⁴. In considering the issues which the enduring consultation document will need to address, we have been conscious of these issues. However, rather than reiterate each issue in this letter, we have sought to include them in a series of key themes for the consultation process (see section below on key themes).

- **Short, medium and long term policy challenges** - We are conscious that the enduring regulatory regime for offshore electricity transmission should be capable of promoting the efficient development of infrastructure to connect round 2 offshore wind generation and round 3 offshore wind generation and, while recognising that it will be important to ensure there is scope for the regime to adapt to future challenges, should also be capable of facilitating potential future development offshore. As such, as part of the consultation process we will need to assess the extent to which issues need to be dealt with in the short term, so as to give certainty for immediate investment, or in the longer term, such that our decisions on issues (which may or may not arise in future as technologies develop) are taken at the most suitable point. Therefore, while many of the issues identified in this letter reflect what can be considered fairly short-term issues, we are actively considering, and would welcome views on, the issues the regulatory regime may need to respond to in the longer-term⁵.
- **Lessons learnt** - We are particularly keen to ensure that any lessons learnt from the experience of the first transitional tender round are addressed prior to future tender rounds and that due consideration is given to the impact of recent developments on new build projects.

Timing

This open letter sets out our initial thinking ahead of a formal eight week consultation on enduring tenders being launched in mid December. We anticipate announcing our decisions of the form of the first round of enduring tenders prior to their expected commencement in Summer 2010.

Background

Before explaining recent developments that we believe may be relevant to the enduring tender rounds and discussing the key themes for the enduring consultation, we give a short overview of the regulatory framework for offshore electricity transmission that was put in place by the Secretary of State at Go-Active. A full explanation of the policy area and its development can be found on the Ofgem or DECC websites⁶.

Over the last 4 years Ofgem and the DECC⁷ have worked together to introduce a new regulatory regime for Offshore Electricity Transmission. One of the key aspects of this

⁴ In particular we raised issues relating to the tender process in our "Updated Proposals for the Competitive Tender Process" document, published in March, and our "Final Statement on the Competitive Tender Process", published in June, and issues related to the regulatory framework in DECC's March "Regulatory Policy Update" and the joint Ofgem/ DECC "Overview of Great Britain's Offshore Electricity Transmission Regulatory Regime", issued in June.

⁵ For example, we recognised that multiple generators may connect via the same infrastructure, that there is a prospect of interconnectivity between offshore assets and that, in due course, offshore infrastructure could evolve in such a way that additional interconnection between European member states is created. While our design has sought to address such factors, new developments may require further clarity or certainty in the regulatory regime for offshore electricity transmission.

⁶ See <http://www.ofgem.gov.uk/Networks/offtrans/Pages/Offshoretransmission.aspx>

⁷ Formally DTI and BERR.

regime is that Government has decided that licences will be granted to OFTOs via competitive tenders run by Ofgem. The outcomes of the tender process will also inform the setting of the revenue streams that parties will be able to receive. This innovative approach to licensing monopoly businesses aims to use competitive forces to deliver value for money to customers and fit for purpose offshore transmission assets for users. The competitive approach also provides the opportunity for new entry and innovation in the sector.

In order to establish this regime, the Government introduced legislation through the Energy Act 2004 and the Energy Act 2008. Among other things, this legislation gave powers to the Secretary of State to amend existing industry codes and licences so as to implement the new regime and also gave the Authority powers to run tenders for the award of OFTO licences⁸.

Before using these powers, the Secretary of State consulted on those changes to the multilateral codes that underpin the electricity market and the transmission licence necessary to facilitate implement the offshore transmission regime under both the transitional and enduring regimes.

In developing these amendments, and in designing other aspects of the regime, Ofgem and DECC recognised the need to ensure that the offshore electricity transmission regime was sufficiently flexible to respond to the potentially changing needs of network users and deliver a co-ordinated offshore grid as economically and efficiently as possible.

Recent Developments

We consider that it is useful to note a number of recent developments in the sector. It is possible that some of the developments set out below may be relevant to the scope of the enduring tender consultation.

The Crown Estate

The Crown Estate (CE) is a key stakeholder in the offshore electricity transmission process given its role in awarding and amending leases to generators. Three recent amendments to Crown Estate policy could impact on the design of the regulatory regime for offshore electricity transmission.

- The third round for offshore wind farms leasing proposals was announced by the CE on 4 June 2008. The CE has also determined that potential developers of Round 3 offshore wind generation should be invited to bid for leases to develop one or more of nine development zones. The CE announced that successful bidders will have exclusive rights to develop windfarms in specified zones (in partnership with The CE). The CE tender process is currently underway with an announcement of the successful developers for each of the zones expected this year.
- In July 2009 the CE announced plans to offer Round 1 and 2 offshore windfarm operators the opportunity to apply for area extensions, which may increase generation capacity from that additional granted to the developer, where appropriate. The proposals are designed to realise additional offshore wind capacity in relatively short timescales.
- The CE has also announced that it will extend the period for which leases are granted to 50 years.

⁸ The legal framework for the competitive tender process is provided for in The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2009 (the Regulations) that came into force on 2 June. The Regulations set out the requirements that offshore developers need to satisfy in order to qualify and enter a tender process, the process for bidders and the provisions for disqualification from, and cancellation of, tenders.

Strategic Environmental Assessments in Scotland

The Scottish Government has identified ten successful project developers which have been awarded site exclusivity. This gives them security over their chosen sites and allows them to commence site survey works and instrument deployment which require the permission of the CE. On the 23 January, the Scottish Government formally announced the launch of a Strategic Environmental Assessment (SEA) for offshore wind; a process expected to take 12 months to complete. The CE is working closely with the Scottish Government and the grant of any agreement for lease by the CE will be subject to a favourable SEA outcome. A lease which enables the developer to begin construction works will only be granted by the CE once the developer has conducted a site specific Environmental Impact Assessment (EIA) and obtained statutory consents and permissions from the Scottish Government.

The Third Package

A package of legislation on EU gas and electricity markets (commonly referred to as the –Third Package), entered into force on 3 September 2009. This follows adoption by heads of state and national energy ministers at the EU Council of Ministers meeting on 3 July and publication in the EU Official Journal on 14 August 2009. The objective of the Third Package is to liberalise further EU energy markets. One of the areas covered by the Third Package is unbundling which essentially involves the separation of electricity generation and/or supply from transmission. The Third Package envisages a number of options for unbundling. The default position is that of full ownership unbundling, the provisions for which are set out in Article 9.1 of Directive 2009/72/EC (the Electricity Directive). Alternatively, the Independent System Operator (ISO) model and the Independent Transmission Operator (ITO) model (set out in Article 9.8 and also Article 13 and Chapter V of the Electricity Directive respectively) *may* apply where, on 3 September 2009, a transmission system belongs to a vertically integrated undertaking.

The Third Package requires that Ofgem certify, by March 2012, all Transmission System Operators, the definition would appear to include OFTOs (this is a point on which representations are invited and which Ofgem will consider further in due course), as compliant with full ownership unbundling, or potentially one of the alternative models. Ofgem will be separately consulting on the various issues in due course.

Offshore Development Information Statement

Licence condition C4 of National Grid's licence requires it to produce an annual 'Offshore Development Information Statement'. The first statement, which is expected to be published by the end of 2009 to be consulted on, will set out a range of future scenarios for the development of the offshore transmission system. The statement is designed to provide information about the likely impact of possible future scenarios on the transmission system and to facilitate improved decision making and coordination by offshore generation projects including the CE and also assist potential bidders in framing their bids.

Ongoing onshore policy developments

In the course of consulting on a regulatory regime for offshore electricity transmission, we have been mindful of a number of ongoing policy development processes and workstreams which could impact on the offshore transmission regulatory regime.

In particular, we are mindful that Secretary of State intends to legislate to amend transmission access arrangements, that Ofgem is consulting on the incentives which transmission licensees should face to encourage 'anticipatory investment' (i.e. investment ahead of a financial commitment from users where there is, on the balance of probability, a need for additional capacity) and that proposals have been raised which, if not vetoed by the Authority, could amend the charging regime.

Operational experience of the first transitional tenders

The current operation of the first round of transitional tenders will provide a robust test of the processes designed by Ofgem. While running the tender process we will consistently evaluate the effectiveness of the process and, where appropriate, consider whether there is a need to update processes based on lessons learnt for both the second transitional tender round and the enduring tenders.

Key Themes

This section considers the key themes, which stem from the developments and issues outlined above, which we consider our consultation process may need to focus on in order to prepare the offshore electricity transmission enduring regime which will commence post Go Live.

Timing of OFTO appointment

We note that Round 3 leases are likely to be granted by the CE over the course of the winter. However, some of these projects are not likely to come on-line until 2017 (though Round 2 projects would be expected to connect more quickly). This raises question around the timing of enduring OFTO appointment. There are several different areas to consider in relation to this theme including:

- **OFTO Risk profile: Early vs Late appointment** - We recognise that in some cases a generator may look to appoint an OFTO at a very early stage of the development, such that the OFTO can carry out the entirety, or vast majority, of the consenting and surveying work for the transmission connection. An early appointment would place these risks with the OFTO and would likely lead to some risk premium in the bids made in the tender process. Conversely, it may be that the generator prefers a relatively late appointment for the OFTO. In this case the generator would likely need to take on some of the pre-construction works and hand these rights over to the OFTO upon appointment (see issue below).

In either case, we will need to consider the extent to which these risks are best managed by the OFTO (and the potential use of contingencies) and, recognising that we proposed to allow costs of some pre-construction work undertaken by the generator to be recovered in our March tender document, clearly the define the scope of these works.

- **User Commitment** – We need to consider whether the current level of user commitment that the generator provides is sufficient if it requests that an OFTO is appointed at an early stage.

Treatment of pre-construction costs and information

As set out above and in previous consultation documents, we expect to allow developers to be able to recover the efficient costs of pre-construction works at, or shortly after, licence grant. However, we will be considering through the enduring consultation process the items that may be included in the envelope of developer pre-construction costs. We are keen to set this envelope so as to ensure that there is the most effective competition for construction expenditure whilst also ensuring that the tender process best facilitates the timely development of offshore connections. We also recognise that we need to consider supply chain aspects when defining the pre-construction envelope and we will be considering how to ensure that sub contractors who have undertaken pre construction works for the developer will not be given an unfair advantage in the tender process.

We anticipate that where such works are undertaken it would be necessary for an asset transfer agreement to be developed as part of the tender process, such that developers can

recover relevant costs assessed by Ofgem as economic and efficient from the successful bidder. We would expect that information resulting from these works would be placed in a data room to be accessed by bidders.

Treatment of future capacity increase

We recognise that the nature of Round 3 leases and, to some extent, the CE's decision to offer extensions to Round 2 leases may lead to challenges for developers in deciding upon the optimum connection application to submit to the NETSO. It may be that there is some degree of uncertainty as to the quantum and timing of generation capacity being bought on-line. As such, there are two possible approaches that could be taken to providing connections to developments that face these challenges:

- Transmission assets are built to deliver the initial phase of the generation development, with subsequent connections being built to deliver latter phases; or
- Certain transmission assets are initially oversized (e.g. landfall cable duct) for the initial phase of the generation development, with a view to providing capacity for subsequent developments.

We recognise that it may be that the second of these options can deliver the most economic and efficient network solution in the long run. In considering this issue we would expect to consider which party should make the decision to provide additional capacity (noting that the modularity of offshore infrastructure may naturally create some excess capacity and recognising the interaction with the role of the NETSO), the generators financially supported preferences and the information required for consideration by Ofgem when a tender specification is being developed and the way in which the risk that additional capacity is underused is allocated.

This theme also relates to the incentive regime that the OFTO is exposed to for making incremental investments. Under the transitional regime parties face incentives to expand capacity, both through capital expenditure (up to a limit of circa 20% of transfer value, subject to approval by the Authority) and through innovative options which increase capacity without capital expenditure. Depending on the prospect of expansion, and any ability on the OFTO's part to oversize the asset, we may need to consider whether the 20% value remains appropriate.

Risk management, Refinancing and incentives

In designing a policy framework for offshore electricity transmission, the Government and Ofgem have identified the various risks faced by offshore parties, considering whether those risks are manageable and, if so, who is best placed to manage them and reflecting outcomes in the regulatory framework through incentives or cost sharing mechanisms. We consider that this approach remains robust while recognising the need to consider whether features of the enduring regime create different risks to the transitional regime and hence whether additional mechanisms for managing those risks are needed.

We have also previously explained that, while there will be no claw back of refinancing gains under the transitional arrangements, we will consider whether it is appropriate to include such a mechanism under the enduring arrangements to ensure the appropriate sharing of refinancing gains.

More generally, we may need to consider whether the incentives which are applicable under the transitional regime need to be flexed or updated given the circumstances of enduring projects. In particular, we consider that the prospect of interconnectivity offshore may raise questions about the design of the availability mechanism, capacity expansion and future network development which may also interact with the design of incremental capacity incentives.

The Role of the NETSO

In previous consultations by Ofgem/DECC in November 2008 and March 2009 we outlined the important role we would expect the NETSO to play under the enduring regime. We noted that as system operator, NGET has an obligation under the Electricity Act 1989 "to develop and maintain an efficient, co-ordinated and economical system of electricity transmission". In the light of this, we outlined that we would expect NGET to be proactive in its approach to offshore network development, being responsive to the requirements of developers and OFTOs. In this context, there are a number of issues that we may need to consider further, including those set out below.

We noted that under our proposed approach for the enduring regime, developers would approach NGET for a connection offer and that, while the detailed requirements of its response will be a matter for NGET to manage in accordance with its licence and the Connection and Use of System Code (CUSC), we would expect NGET to be able to offer offshore connections in a number of ways, including:

- A connection designed for a single project between the onshore grid and the offshore connection point,
- A connection designed for a single project on a phased development basis – i.e. a phased increase in cables over a defined period,
- A connection designed for a group of separate projects, which could also be phased.

We would expect to monitor the process through which connection offers are made to offshore generators to ensure that, in all cases, it is non-discriminatory, facilitates the achievement of NGET's licence obligations and delivers best value for consumers. In particular we will be mindful of any commercial incentives which may exist for the NETSO to favour particular connection designs.

We also set out our view that in Round 3, the zonal development partner would be able to work with the NETSO to establish its high-level connection requirements, which, if approved by the NETSO, would be set out in a bilateral connection agreement. We proposed that tenders would then be run on the basis of these requirements, recognising that this could lead to more coordinated network development where that is specifically sought by developers.

Qualifying Project Pre-Conditions and Tender Entry Criteria

Under the transitional regime, developers are required to demonstrate to our satisfaction that they have met a number of pre-conditions criteria in order to participate in the regime. These are set out in the Regulations. In a similar way, the Regulations also set out pre-conditions and criteria for the enduring regime. We consider that it is important to ensure that these remain fit for purpose, and are consistent with other parts of the overall regulatory framework.

The Third Package may have consequences for the parties which are able to participate in the regime and may create a need for an assessment by Ofgem of prospective bidders' compliance (which would clearly have an impact for the timing and number of stages within the tender process).

For enduring projects, there may also be a need to review the effectiveness of the measures by which parties which are seeking to develop offshore generation signal their commitment prior to the commencement of the tender process. This is necessary to mitigate the risk that costs are incurred inefficiently or, at worst, a stranded asset is constructed.

Stages and Timing of the Tender Process

We are also conscious that there may be a need to update and refine the stages and timings of the tender process. Updates in this area may be driven by differences in scale between enduring and transitional projects (which might, for example, mean that bidders require more time to assemble bids or that the Authority needs more time to assess bids), lessons learned from operational experience of transitional tenders or additional requirements such as those imposed by the Third Package.

Stages of the tender process – The tender process needs to be structured in as streamlined a manner as possible while ensuring that legal obligations are fulfilled and appropriate checks and balances are in place.

The timing of tender stages - There are a number of features of the enduring regime, for example a greater focus on designing infrastructure, which may mean that the timings of the different stages of the tender process need to be refined. In particular, we consider that the ITT stage may need to be lengthened. There may also be a need to consider whether a total of twelve months is sufficient to operate a fully robust enduring tender process.

Assessment of the Tender Process

For the enduring regime, we recognise the need to adapt our assessment processes to include design proposals. For example, we have already signalled the likely need for the NETSO to advise Ofgem in the process to ensure that design proposals brought forward can be operated by it in line with its duties under its licence and the STC. We are also mindful that there may be other factors we need to take into account, including the way in which we take account of electrical losses in evaluating network design proposals.

As highlighted previously, given the importance of ensuring compatible functional designs, we may also need to consider the desirability of some proportionate involvement from developers in the process of selecting the OFTO.

Supply Chain

In the March document, we proposed to preclude the inclusion of supply chain interests in consortia on an exclusive basis. After further analysis, we concluded that rules on supply chain exclusivity would not be necessary for the transitional regime. However, we retained the ability to determine such rules for the enduring regime. We would expect to further consider the incentives which developers and supply chain providers face to contract on an exclusive basis and to consider the impact that those incentives may have on competition. The tender process is designed to deliver efficient outcomes for customers by harnessing competitive forces. If contracting on an exclusive basis was expected to reduce the number of bidders and the scope for competition to deliver the best outcomes for customers, we may consider whether taking steps to address this would be appropriate.

Next Steps

The issues set out above consider some detailed policy and process questions. We also recognise the need to provide, to the extent practicable, certainty to developers and investors about the form of an enduring regulatory regime for offshore transmission. We are committed to working with market participants, including potential OFTOs, financiers, generation developers, DECC and the Crown Estate to fully consider these issues over the remainder of 2009 and first quarter of 2010. At present we expect to issue a consultation document in late December 2009 and deliver a decision document in April 2010.

We would welcome responses regarding any of the issues raised in this document. We will publish any responses received on the Ofgem website, however should you wish your

response to be treated as confidential please mark it as such. Please send responses to the address below by 27 November 2010.

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Should you wish to discuss the issues raised in this document, please contact Sam Cope on 020 7901 7239 or at sam.cope@ofgem.gov.uk.

Yours Sincerely,

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