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Your Ref:

25th November 2009

Dear Sam,

**Re: Offshore Electricity Transmission: An Open Letter on the Enduring Regime**

This letter gives a brief summary of Warwick Energy Limited's (Warwick's) comments in response to the above open letter dated 5<sup>th</sup> November 2009 on Offshore Electricity Transmission. Warwick sees the open letter as a positive step aimed at ensuring that the next proposed consultation involves the key areas which need to be addressed to make the enduring regime viable.

Warwick's comments on the open letter and key issues for future consultations are given in the following sections.

**Timing of OFTO Appointment**

The artificial limit on the scope of the proposed consultation in this crucial area is our main concern. It is vitally important that this is corrected to enable developers to have the option to minimise costs and delays. Selecting the wrong timing for the appointment of an OFTO could incur delays of up to 5 years for projects.

Warwick supports the concept of making the proposed enduring regime as flexible as possible. The use of flexibility should ensure that the widest range of interested parties take part in the project development, detailed design, construction and operation of both OFTO networks and the associated offshore generators. This should help to ensure that Government objectives for offshore generation can be met, provide full 'customer choice' for developers and avoid discrimination between different offshore wind farm projects.

With the above in mind the following must be considered in the consultation:

- Full range of timing of OFTO appointment from very early through late appointment to 'very late' appointment post contract award/ construction as used in the transitional regime;

- Very early appointment of OFTO – in this case the risks on the OFTO are expected to be high and therefore bids and timelines are likely to be inflated to account for such risks. However some developers may still favour this option and it should therefore be included to provide maximum developer choice;
- Late appointment of OFTO – here the developer effectively takes risk out of the OFTO scope by obtaining necessary consents and in some cases carrying out electrical design. The de-risking of the project should result in more economic and efficient bids from the OFTO, and these benefits can be traded off against increased pre-OFTO costs for the developer;
- ‘Very late’ appointment of OFTO – this model is in essence the same as the transitional regime. In this case full financial close would be reached before an OFTO is sought. This results in the minimum possible overall risk for the OFTO (and therefore reduced risk premiums and timescales) and eliminates the construction coordination risks thereby making the overall project more attractive to funders. The developer would cover all consents, design, contract award and construction as part of a unified project prior to handover of the ‘transmission’ elements to the OFTO. This is very much in line with the features of the transitional regime which Ofgem presumably believes is a viable route for successful project development;
- In all cases economic efficiency would be assured by an assessment of the transfer value of the project carried out prior to the tender process. The assessment would need to account for a reasonable margin and rate of return on any development investment that removes risk from the OFTO. This is equitable since the up-front development work should reduce risks and therefore result in lower bid prices for later bids compared to early OFTO appointment; and
- The above principles should be tested in the transitional regime – the present approach of forcing the transfer of OFTO assets part way through construction at an arbitrary fixed date does not seem to be in the industry’s best interests. It would be far more appropriate to allow developers the choice over transfer date to the OFTO – there seems no benefit in transferring a partly constructed or commissioned asset mid way through the project since this adds risk to already challenging projects.
- In addition to the Open Letter trying to restrict the debate on this subject there seems to be some inference that a single ‘one size fits all’ transfer timeline should apply to all projects. This is not appropriate.

### **OFTO of Last Resort**

The transitional regime enjoys the benefit of an OFTO of last resort. Based on information published by Ofgem and DECC, there is to date no evidence to suggest that this has had a negative impact on competition in the tender rounds for transitional projects. This appears to be a valuable lesson from the transitional regime. Ofgem cited potential negative impact on competition as the reason that there should be no OFTO of last resort in the enduring regime – and this argument no longer appears valid.

Warwick also notes that with the existing enduring proposals there is no assurance that a project can be connected at all. This is in marked contrast to onshore projects where there are license obligations on onshore transmission and distribution companies that guarantee a connection. Warwick therefore believes that the present proposals for repeated tender rounds with no guarantee of a connection being offered are discriminatory. Indeed this approach is likely to at best add delay and at worst prevent viable projects proceeding at all. Indeed these consequences also appear to be contrary to overall Government policy to encourage offshore generation.

Warwick therefore believes that an OFTO of last resort should be included in the enduring regime. This would have the notable benefit of providing developers with the re-assurance that connections will be made available for offshore projects. This in itself will reduce overall project risk and therefore assist in making financing viable for the offshore generation assets. Based on evidence to date there would be no associated negative impact on competition for OFTO licenses.

The option to include an OFTO of last resort in the enduring regime should therefore be included in any consultation exercise.

### **Third EU Package on Transmission Unbundling**

Warwick notes the Ofgem invitation to comment on the proposed interpretation that OFTOs should be subject to EU unbundling regulations. This interpretation of EU rules is a direct consequence of the arbitrary and unnecessary decision to classify transmission offshore as any offshore system operating at 132kV or above.

Warwick notes that similar 132kV assets onshore could be privately owned connection assets or embedded networks - and these would not require a transmission license. As a direct consequence offshore projects are potentially required to fulfil unbundling requirements that would not apply onshore. This is both perverse and discriminatory. For the majority of existing Round 1 and Round 2 projects the scale of the projects concerned and radial nature of the networks means there is no reasonable justification for defining these networks as transmission.

For the above reasons the definition of transmission should be revisited since this is an obvious means of avoiding undue discrimination against offshore networks.

### **Treatment of Pre-OFTO Costs**

As noted above Warwick believes that 'very late' OFTO appointment is a viable and important model. This is supported by the reported progress made in the transitional regime to date which follows this very approach. The overall enduring regime should therefore allow for the option of a similar process to be carried out at the developer's choice. In such cases the economic pre-OFTO costs should be recoverable by the developer.

It is also clear that for a later OFTO appointment there is reduced project risk at the transfer date, and this will benefit all parties by reducing OFTO risks and thence costs. Normally there is a reasonable return on any investment which adds value and reduces risk for potential purchasers. Warwick sees no reason why this basic principle of business should not apply to economic and efficient costs incurred by developers in the pre-OFTO stage. The consultation should therefore include the issue of reasonable margins for developers on costs incurred before an OFTO is involved.

### **Timing and Stages of Tender Process**

Warwick notes the obvious existing limitations in the supply chain for delivery of projects. The present proposal for tender windows serves to artificially concentrate the timing of the bid process. This in turn is likely to place excessive and unnecessary pressure on Ofgem, developers and the supply chain in the entire ITT process - from preparation through bidding, query, evaluation and license award stages. The main justification for tender windows was originally to increase the possibility of a co-ordinated approach to network development, although quite how this would work in reality is not clear.

Obviously there have since been changes in the overall framework since the tender window approach was proposed. The main change is the approach to Round 3 zonal leases by Crown Estates. In addition it is highly desirable that NGET be obliged to prepare a comprehensive annual statement on offshore connection opportunities. In this context the use of tender windows appears increasingly irrelevant and this approach should be revisited in the consultation. Warwick continues to believe that OFTO bids should be triggered as appropriate for each project by the developer – and commence at any time throughout the year. This is in line with onshore practice and would relieve pressure on the supply chain and speed up the project development process.

In relation to the proposed 12 month window for tenders Warwick maintains the view that this is inadequate to allow OFTO's adequate time to prepare bids for new construction projects without building in excessive risk premiums. This issue can be addressed partly by the 'very late' OFTO model. For early OFTO appointment the length of the 12 month window is extremely limiting and is likely to add to costs.

Consultation on how these issues should be addressed, and the further delays that are likely to result for projects, is therefore highly desirable.

#### **Assessment of the Tender Process**

Warwick welcomes the idea that there is a need for greater design and developer input into the tender process. Based on experience with previous projects it is likely to be extremely difficult to assess bids on a level playing field unless the ITT documents are clearly focused and contain suitably detailed design criteria. Hence Warwick believes that there is likely to be a huge challenge to Ofgem to produce such detail even with considerable outside assistance from parties such as NETSO and the developer.

A further point of note is that for late or very late OFTO appointment the consenting process will be completed ahead of the tender process. The consents will include detailed information on design requirements, and the developer is therefore ideally placed to assist the bid process by providing support to Ofgem.

Warwick is therefore in favour of greater involvement of affected parties in the tender process. Consultation on the best means of providing such input would therefore be welcome.

#### **Treatment of Future Capacity Increases**

There is a need to consider capacity increases, particularly for staged projects, and this issue should be included in the proposed consultation.

The provision of additional capacity ahead of generation needs to be encouraged where appropriate – so long as there are suitable mitigating measures to avoid the potential adverse impacts of stranded assets. It is clear that developer preferences and demonstrable plans for offshore generation should inform the approach to capacity in any OFTO network. Equally given the onshore initiatives to encourage anticipatory reinforcement similar incentive mechanisms should be considered for the OFTO regime as well. Clearly anticipatory investment is one way of connecting projects in a timely way whether onshore or offshore. The availability of offshore connection capacity would also be of significant benefit in demonstrating project viability and thence raising project finance for the offshore generation assets.

Warwick notes that for the transitional regime the 20% extension limit appears both arbitrary and unnecessary. As pointed out in previous consultation responses it is

unlikely to foster innovation by the OFTO. In the context of potentially different approaches being adopted for the enduring regime the transitional regime provisions should also be reviewed.

### **Risk Management, Refinancing and Incentives**

Warwick would welcome consultation on possible deviations from the approach used in the transitional regime for these key issues. For the enduring regime the level of risk for the OFTO – particularly for early appointment – is such that economic and efficient bids are unlikely to be possible. While early appointment of an OFTO may be desirable for some developers (eg those without good electrical engineering expertise) this does little to foster cost effective bids since risks will be extremely high. It therefore seems reasonable to increase flexibility in the regime to help achieve an overall best solution for all parties concerned. There is a real danger that the requirement to bid a fixed 20 year revenue stream before even basic design parameters and consenting restrictions are known will lead to excessive risk (and thence cost premiums) and project delays. This is contrary to overall objectives of the regime and some means of addressing such critical issues is therefore needed.

One possible option to address the above scenario might be to split the OFTO tender into development and construction stages. The latter stage would be triggered once the design parameters and consenting conditions are known. The main OFTO bid would then be at a stage when risks have been identified and designed out – thereby allowing greater efficiencies.

Warwick also notes that financing costs are likely to be risk dependent and therefore options to refinance part way through a project could bring significant savings.

Overall then it appears that consultation on all of these issues is essential.

### **The Role of the NETSO**

It is essential that there is flexibility to allow NGET the opportunity to offer connection designs that best meet overall objectives. This includes options to provide early and staged designs as well as non standard or customer choice variations. The latter are a potentially valuable means of providing early connection but the current application system does little to encourage such designs being adopted. In particular unless identified in advance by the applicant, NGET has no requirement to identify or adopt such designs. This is despite the fact that NGET is in the best position to identify potentially beneficial customer choice designs.

The three month connection application turn around time also does little to foster innovative thinking by NGET. By necessity the NGET process must be focused on getting connection offers out to applicants, rather than finessing designs which could offer major benefits for all concerned.

The possibility of NGET carrying out developer commissioned feasibility studies in advance of applications has also largely been lost to the industry. This is due to the present level of connection applications, which must be a priority under present NGET license conditions, and with known limited resource issues. Some means of recognising feasibility studies and introducing license or guaranteed standards to ensure NGET is obliged to carry out such feasibility studies in a timely manner should be considered.

Warwick also notes that in the present context of a step change in generation connections the NGET requirement *"to develop and maintain an efficient, co-*

*ordinated and economical system of electricity transmission" may not be the overall most economic or efficient means of meeting Government objectives.*

The above license obligation places a clear cost focus on the transmission system – and does not provide an overall trade off of early connection of generation and carbon benefits against transmission costs. This is particularly limiting for OFTO networks where the extent of the new networks and distance from the existing transmission system opens a multitude of possible connection options. The overly restrictive emphasis within the license on cost minimisation by NGET not only does little to foster timely connections but may actively work against it.

Warwick believes that the system should be made as flexible as possible – for instance allowing onshore connection offers to be made to offshore wind projects.

### **Supply Chain Limitations**

There are known limitations in the supply chain in respect of OFTO networks. In particular sources of high voltage offshore cabling, reactive compensation and DC network solutions are limited to a small number of providers. Warwick believes that this is a serious threat to OFTOs being able to providing economic and efficient infrastructure. In particular suppliers are likely to be well aware of potential competitor costs and their capacity to bid different projects.

Indeed the above is such an issue that the validity of a “competitive” model is questionable. There is a real danger of cartels existing to control prices thereby maximising supplier profits. Warwick notes that major developments on the onshore network are now carried out via alliance partnerships – and these are presumably viewed by NGET as the most economic means of project delivery. This approach is in direct contrast to the supposed “competitive” approach being proposed for offshore networks.

One possibility to improve competition might be to put in place measures to ensure that main equipment suppliers must bid to multiple OFTOs and also for multiple projects in order to qualify for eligibility to supply a particular OFTO; i.e. an approach more like alliances but retaining the need for major manufacturers to compete against each other.

Warwick would welcome consultation on any measures that might be put in place to ensure that active competition between suppliers is encouraged. Consultation on supply chain issues is therefore essential.

### **Summary**

Warwick believes there remain major difficulties with the entire OFTO proposals and these can lead to increased costs and long delays for the projects involved..

The most significant means of mitigating against these difficulties is to allow maximum flexibility in all aspects of the regime. This should include as a minimum the timing of OFTO entry into a project – i.e. variation from early to ‘very late’ OFTO appointment. The option of continuing to use the transitional regime model should thus be considered – i.e. OFTO asset take-over to take place post construction, thereby minimising OFTO and construction risks, and mimicking the already demonstrably successful merchant approach to offshore developments. This option is also likely to lead to the shortest development time for projects allowing new renewable energy capacity to start production as soon as possible.

Other major areas of concern include the lack of an OFTO of last resort; treatment of pre-OFTO costs; risk management, re-financing and incentives; role of NGET; and supply chain issues.

Warwick still believes that extending the existing onshore transmission franchises under the 'connect and manage' ethos could match the stated aims of connecting major increases in offshore wind capacity in a timely and efficient manner. It would also provide a more strategic and coordinated solution to this critical challenge for the UK and better facilitate interconnections with other grid systems in the EU. This can still be achieved for projects that would otherwise fall into the enduring OFTO regime without disrupting development timetables.

Despite the numerous fatal flaws in the OFTO proposals Warwick continues to make constructive suggestions in response to Government, Ofgem and NGET consultations on the subject. These could help limit the damage if these proposals are imposed on a reluctant industry.

The preferred outcome from this open letter is that the subsequent consultation allows the maximum flexibility to be built into the enduring regime to ensure that it best meets the needs of the industry and UK consumers.

I trust the comments are clear however please do not hesitate to get in touch if you require any clarification on any of the points made.

Yours sincerely,

Mark Petterson  
Director  
Warwick Energy Limited