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Dear Sam

Offshore Electricity Transmission – Consultation on the Enduring Regime

Centrica welcomes the opportunity to respond to the consultation on the Offshore Electricity Transmission Enduring Regime. This non-confidential response is on behalf of the Centrica group of companies excluding Centrica Storage Ltd.

Centrica remains committed to the Offshore Regime and is seeking to work effectively with Ofgem to ensure that the enduring arrangements efficiently facilitate the scale of investment envisaged for offshore wind projects.

To this end our primary concern is to ensure that early enduring projects can be facilitated through the OFTO tender process without incurring any delay to planned commissioning. This is essential to facilitate investment based on DECC's accelerated build incentives and delivery to The Crown Estate deadlines for Round 1 and 2 extensions.

Ofgem should allow flexibility in the regime to permit developers to do everything necessary to ensure a project is not delayed and provide critical confidence for investment. This would mean that it might be necessary to allow developers to undertake procurement activity, place contracts, or potentially even begin any required construction, with the intent that this would be handed over to the OFTO as appropriate. As a minimum, this flexibility would be required for all projects that do not have the option of an early OFTO appointment. It would also ensure that there is no hiatus in the supply chain in which no contracts are placed with suppliers as there is no OFTO appointed to do this. This hiatus would occur at the time where Great Britain needs these to provide confidence to this part of the industry.

We address the individual questions posed in the consultation below.

Section 1

Ofgem have indicated that they want a stronger undertaking from developers to commit to transfer assets in the second transitional regime. It would be useful for this to be clarified as Centrica believes that developers are committed to transferring the assets on terms that are not commercially disadvantageous. Centrica is concerned that the terms of a model SPA may not be flexible enough to meet each individual project and therefore be acceptable to and just for the developer.

Section 4

Centrica is concerned that the costs of the enduring tender process have been signalled as being significantly in excess of those for the transitional round. Whilst we understand that Ofgem needs technical skills to be able to evaluate the bids, there needs to be transparency that the costs are reasonable and not excessive. It is not clear how downward pressure will be applied to Ofgem's costs.

Do you agree with the proposed approach to initiating the tender process?

Centrica believes it is essential that the first enduring tenders are commenced this year. As mentioned above, a key element to be considered prior to implementing the enduring regime is to ensure it does not in itself hinder timescales of the initial enduring projects as an unintended consequence.

In relation to tender windows, Ofgem state (in 4.20) that 'We believe that the flexible approach should ensure that a generator is able to apply for OFTO appointment at a point which best reflects its specific project timetable'.

Centrica notes that for the initial group of enduring projects, the option of an early OFTO appointment does not exist. Additionally, the envisaged late OFTO appointment process also requires a substantial period between OFTO selection and transmission asset commissioning. This period could easily be in excess of desired commissioning. Centrica believes that in the document there is some evidence of flexibility to accommodate these issues and we need to be assured that Ofgem intends to apply flexibility in the regime to accommodate these projects in meeting their planned commissioning dates. Where the developer needs to undertake activity to ensure they meet their planned commissioning dates (for example, addressing issues associated with the supply chain for crucial items), this should be allowable with the affected developers working closely with Ofgem to ensure they meet all relevant transparency, economic and efficiency requirements so as to be compatible with Ofgem's duties allowing them to consent to transfer (and/or novation) to the future OFTO.

Centrica is concerned that Ofgem would have the vires to choose when to tender for an OFTO even though the developer has met all the pre-conditions of a qualifying project. This could potentially include delaying a project to wait for another to catch up to enable both to be tendered as one. The circumstances in which Ofgem exercises this power should only be where a clear and obvious quantified benefit from doing so has been identified that exceeds the downside of delaying the project. In addition, the benefit and the costs of delaying a project may not be attributable to the same party, but may still lead to an overall benefit. Centrica would like to see a means by which these costs are reclaimable.

Centrica would also like to see greater clarity around the envisaged process for coordination and clear guidance on how Ofgem envisages parties engage in the co-ordination process. Would Ofgem be putting any rules around how parties should engage such that they can avoid claims of discrimination?

Should there be an earliest or latest point (relative to the connection agreement held by the generator) at which the generator should be required to request an OFTO appointment and when should that be?

It may be reasonable to set an earliest point at which a developer can request an OFTO as it could be difficult for a bidder to price a project that delivers too far in the future. However, we would note that there is a natural incentive for a developer to not initiate a tender too early as a significant risk premium would be likely to be factored into the bids.

A 'late' OFTO appointment in the enduring regime (without the flexibility mentioned above) still requires the OFTO, once notified that it has won the tender, to place orders, enter contracts and then construct the transmission assets. With current lead times on items such as cable, transformers and vessel bookings, a late OFTO appointment could still result in a substantial amount of time (in excess of 3 years) between OFTO licence award and commissioning of the OFTO transmission assets. With a 14 month tender process, this means that 'late' OFTO appointment is probably rather misleading. As mentioned previously, there should be flexibility for the initial enduring projects that do not have the option of an early OFTO appointment, and for which a 'late' OFTO appointment is also too late, to be able to undertake necessary work to progress a project concurrently to the OFTO tender process. In particular, the developer should be able to undertake procurement and contract award.

Do you agree with the proposed amendments to the qualifying project pre-conditions and tender entry conditions for the enduring regime?

Centrica notes that the precondition that the developer has entered into a Crown Estate Lease should be that the developer has entered an Agreement for Lease with The Crown Estate.

Developers would need to have sight of the Ofgem defined, standard pre-construction works transfer agreement prior to undertaking to enter this. Given the initial tenders for the enduring regime are due to occur in June 2010, we look forward to seeing this soon. Any standard transfer agreement should be flexible enough to take into consideration project or site-specific requirements and its issue should follow a meaningful consultative process with developer's. Centrica considered the model sale and purchase agreement proposed for use in the first transitional round to have significant flaws in that its terms did not reflect the commercial reality of the transaction.

We note the final condition that the developer has complied with other such conditions as the Authority may deem are necessary in relation to that particular tender exercise. It is not helpful for Ofgem to include such a catch-all condition without providing some indication of what elements this might include. It is difficult for a developer to plan for potentially open ended risks and questionable whether a reasonable and prudent company could sign on to such an open ended liability.

Centrica believes it is reasonable that to enter a tender, a project should not have an expected energisation date that is at a point too far in the future as this would be likely to make it impossible for a bidder to price accurately. This would be likely to add a significant premium into their bids. However, to be clear, we do not believe it would be reasonable as part of a tender entry condition to include any obligation on the developer to fix a date by which it has to energise by as there are many contingencies which could affect that date, which may not be under developer control, for example, provision of transmission assets.

Do you have views on the time of year at which a tender window should be held?

Centrica believes that this may be dependent on when a project goes to tender so should be decided on a case by case basis. For example, there might be benefits for an early OFTO

appointment to be completed at a different time of year than a late OFTO appointment. This could be addressed by having more than one tender window per year.

Do you have views on the best method of dealing with contingency costs?

Contingencies should not be an open ended pass through and Centrica supports a defined series of cost items that would be included as contingency items on a case by case basis. In each case, these PT costs should be subject to rigorous challenge to protect consumers' interests

What is your view on the capping of the contingency and any associated incentives?

Centrica believes that a method by which downward pressure is applied to contingency costs is essential. We would need to see a detailed incentive mechanism design to determine whether we believe this is the most effective mechanism for reducing these costs, noting that an additional incentive mechanism could add undesired complexity to the regime.

Which items do you consider should be defined as pre-construction costs (and why)?

Any pre-construction works that are included in the dataroom offer transparency and visibility to bidders to price their bids. Therefore, these should always be recoverable, subject to reasonable tests to ensure that they have been economically and efficiently incurred. There is a natural incentive on developers to ensure this is attractive to OFTOs as there is currently no OFTO of last resort provision.

Centrica believes that as a minimum, there should be flexibility in what can be defined as pre-construction costs, and this is particularly for the early enduring projects. As mentioned above, it is critical that the developer can confidently progress a project that enters the early enduring regime such that there are no overall delays due to the tender process. For these projects which, due to the need to meet the developers commissioning plan, do not have the option of early (or potentially not even an option for late) OFTO appointment, Ofgem should work closely with developers to ensure that costs are being incurred economically and efficiently and that any contracts entered into are constructed with the view to transfer or novate to the successful OFTO bidder following Ofgem approval. It will be essential as part of this process for the developer to be confident that, subject to them providing appropriate evidence etc, this will be an acceptable route forward. Whilst Ofgem may naturally be concerned about fettering their discretion, the key will be for Ofgem to work with the developer to ensure that the consumer interest is sufficiently protected by the developer tender process, then there is no stranding or uneconomic/inefficient risk associated with this type of "pre-approval".

Once the enduring regime has been embedded and the developer has the option for early OFTO appointment, then a more clearly defined set of pre-construction costs that can be claimed would be more appropriate.

Any list of items defined as pre-construction costs should include the ability for developers to be able to undertake the consenting for the transmission assets.

Additionally, Centrica notes that Ofgem is not opposed to developers working with potential OFTO bidders subject to transparency requirements to enter information into the dataroom. Centrica welcomes this flexibility and agrees it would be a sensible approach, although it

would be useful to have some guidance of how this might work in practice, in compliance with the Tender Regulations, as we would not wish to risk falling foul of the disqualification criteria.

Do you consider that an Ofgem defined, standard pre-construction works transfer agreement is the appropriate vehicle for managing the transfer and payment of pre-construction costs?

Centrica understands that there might be some benefit in having a standard framework provided such document has been consulted on and approved in advance and has sufficient flexibility to incorporate project specific requirements. How workable the standard agreement would be depends on the detail included in advance by Ofgem. There needs to be prompt, detailed and accurate guidance in this area with due consideration to commercial drivers. We look forward to seeing this well in advance of the deadlines for meeting the pre-conditions of the first enduring regime.

Given pre-construction works are ultimately undertaken at the risk of the developer, Ofgem should have some consideration of factoring this into the value of the works.

Centrica believes that some thought needs to be given to how certain contracts would be novated and understands that Ofgem may already be looking at this. For example, it is not clear whether OFTOs would be willing to take on contracts with liquidated damages provisions to lay a new cable were they to share a cable corridor with an existing cable. Also, where a contract is novated to an OFTO that has liquidated damages for the developer, how will this link be retained?

Section 5

Do you agree that the tender specification should be based on the connection application, with information also being provided relating to any pre-construction works undertaken?

Yes. There should be a clear manner in which the developer can determine the specification and be confident that bids should be aligned to that specification.

Do you agree that bidders should be given flexibility to respond to this specification as they see fit?

Allowing bidders to respond as they see fit allows for potentially innovative solutions but sufficient weight should be given to the initial specification set by the developer. The critical element will then be how Ofgem will evaluate the variant bids. Ofgem should engage with the developer to understand the impact of the variant bid such that any delays or impacts (positive or negative) on the developer are taken into account prior to selecting the preferred bidder. The potential to have a second stage connection offer that varies significantly from the first stage connection offer is a significant financial risk for the developer. In all cases, (but particularly where a specification has initially been tightly defined), there should be a requirement for Ofgem to undertake a full impact assessment. This would need to demonstrate clear and quantified costs and benefits including how a significantly varied second stage connection offer might impact the project's timescales or viability for the developer.

Ofgem should also clarify how developers should expect any out of pocket costs (as a result of acceptance of a variant bid) will be treated. For example, there should be a means for compensation for the developer if a deviation causes a time delay which renders the consents (sought by the developer) redundant

Do you agree with our suggestion not to incorporate capacity oversizing into the enduring regime (unless financial commitment is provided for that capacity)?

It is not clear that having no means to oversize capacity would provide best value for future consumers. Having a more holistic view which allows for low regret investment could result in long term efficiencies and costs overall being lower (which would ultimately provide benefits for the consumer). However, we acknowledge that there may be difficulty in how you effectively remunerate and charge oversized capacity.

Section 6

Do you consider that supply chain exclusivity should be permissible under the enduring regime? If not, do you have proposals for enforceable measures for precluding it?

The consultation adequately outlines the potential issues from permitting and from attempting to prevent exclusivity. Centrica does not believe that any additional measures should be in place to exclude exclusivity. Were competition issues to manifest themselves then these should be dealt with at that time under the measures already available. Centrica notes that temporary exclusivity could effectively occur by default at any time where agreements have booked up all of the supplier's capacity. It is not clear whether Ofgem would intend this circumstance to be captured.

Do you consider that the option of bidding on the basis of indicative costs and tendering after appointment has merit?

This option would only have merit if it can be shown to both reduce the entire timetable from developer initiating a tender to the commissioning of the offshore transmission assets and demonstrate increased competition to reduce costs. With the supply chain held at arms length until late in the process it is not clear that this would be the case in terms of timescales, although there could be some competitive benefits due to simplifying the ITT stage.

However, Centrica would query whether bidding on the basis of indicative costs would be enough to make a firm bid. There would be no benefit if this simply meant that the price risk sat solely with the developer by allowing the OFTO to pass on any difference between the indicative costs and the final cost. Similarly, if the OFTO could not pass on this cost, this would be likely to result in the OFTO factoring in a risk premium into their bids. A competition that is based on a comparison of firm bids (as opposed to bids based on indicative costs and subject to change) would give greater confidence that the best OFTO is selected and consumer interests are ultimately protected.

Do you support our minded to position that explicit steps to facilitate new entry should not be included in the enduring regulatory regime?

Yes.

Should we include provisions in the enduring regime to ensure that access to offshore cable capacity and to offshore cable routes is made available? If so, what form should those provisions take?

In regard to offshore cable routes, it should be noted that allowing access should also come with commensurate risk. A new party seeking to lay cable next to an existing offshore cable would be likely to have to take on significant liquidated damages provisions in order to compensate for any disruptions to the existing cable. This is likely to be a natural barrier to sharing cable routes.

Section 7

Do you support, or have alternative, proposals for amending the key stages of, or otherwise stream lining, the tender process?

Centrica supports rationalising the qualification process allowing more time for potential OFTOs to put together their detailed bids at the ITT stage.

Ofgem states in 7.10 that “We propose that the PQ stage would require demonstration of both past experience of designing and constructing relevant assets and...”. We note that whilst we value past experience, we are mindful that such a requirement might be difficult for a new entrant to demonstrate. It would be useful for Ofgem to clarify how this statement compliments the desire to attract new entrants.

Do you consider that the timings outlined will provide sufficient time for bidders to develop robust tender submissions and Ofgem to assess them?

Centrica would be concerned if the proposed timings were not considered sufficient time to develop robust tenders. Current proposals would take 13 months just to get to preferred bidder stage. The longer the timing, the greater the risk that the OFTO tender process could result in unnecessary delays to projects that might stall whilst waiting for OFTO appointment.

For early enduring projects where no flexibility is given to developers to progress projects as required, this tender timing is likely to result in projects being critically delayed (potentially to the point of threatening the investment) and a hiatus on placing contracts with the supply chain that would be likely to result in significant detrimental impact to the industry.

In order to ensure an effective and timely procurement process through the supply chain, how long should the ITT stage last?

This might depend on how many projects are in any one tender window and whether or not the developer can carry out the procurement activities as per Centrica’s recommendation. The disadvantage with infrequent tender windows is that workload for bidders, suppliers and Ofgem will be concentrated into certain periods which extend the time required at each stage for all. Centrica would support multiple tender windows within a year.

Section 8

In which areas should we allow variant bids?

Allowing variant bids adds an element of uncertainty for the developer. Where an overall benefit has been demonstrated from a variant bid, it may be the case that costs are redistributed amongst the parties. If this redistribution results in additional cost to the developer, clarity is required that this can be claimed through the OFTO process.

At the very least, Centrica supports limiting the areas for variant bids and believes that bidders should be required to demonstrate how variant bids would deliver benefits to consumers.

How should variants be treated in evaluation?

When Ofgem is evaluating variants, there should be close engagement with the developer to determine how acceptable that variant is to them. For a variant to be accepted there would have to be clear and demonstrable benefits which can be achieved without deterring the developer from continuing, i.e there should be no delay to delivery of the project in its entirety, unless the developer can be suitably compensated for lost generation etc.

Do you have a view on the factors we should consider in evaluating bids?

It is not clear how transmission losses will be considered when evaluating bids. Centrica does not believe that this should be afforded much weight in the evaluation process. Clearly generation at extremes of the network will increase the losses on the system as a whole. However, the electricity lost from offshore wind will be renewable and hence the carbon impact of those losses will be zero. The only impact of slightly lower losses is that slightly less carbon emitting generation would be displaced. Whilst it is desirable to maximise the conventional plant displaced, this needs to be assessed against the cost.

It would not be reasonable for the renewable generator, who is by the act of investing, contributing to significant carbon reductions, to have to potentially pay an increased revenue stream for a transmission solution that might only marginally decrease carbon emitted from a marginal decrease in transmission losses. It would be a much more negative carbon reductions outcome were the investment to not occur.

Ofgem should also bear in mind the BSC modification P229 'Introduction of a seasonal Zonal Transmission Losses scheme' that, if introduced, would result in transmission losses also being targeted on the generator. Having to factor into account higher costs to minimise transmission losses would increase the hurdle rate prior to a developer investing.

OFTO of Last Resort

Centrica notes Ofgem's position on OFTO of last resort. We continue to have concerns about this decision and would welcome Ofgem making provision for review at a later date. It might also be prudent to allow for OFTO of last resort provisions for early enduring projects where developers need to undertake work in advance of OFTO appointment to ensure projects are not delayed.

We would also like some assurance that, in a regime without OFTO of last resort and where Ofgem has the ability to determine insufficient competition has existed and as a consequence do not believe they can identify a preferred bidder, the developer is engaged prior to this decision being taken.

Section 9

How, if at all, should the existing availability incentive be updated for the enduring regulatory regime?

Centrica understands that Ofgem is aware of current issues with the existing availability incentive in the draft OFTO special licence conditions and is seeking to rectify these.

Ofgem needs to ensure that they create a mechanism which delivers the principles of:

- Ensuring that a significant outage in any month of the year would result in the maximum penalty; and
- That the banking mechanism operates in a manner where it provides appropriate incentives for the OFTO (that is, it does not excessively reward the OFTO such that it can offset significant future outages, or excessively penalise the OFTO such that the incentive reaches its maximum level and becomes redundant).

What is your view of the inclusion of a re-financing claw back mechanism?

Ofgem should reconsider the position on sharing refinancing gains. Centrica disagrees that an adjustment mechanism would weaken the incentive for OFTOs to be innovative in their financing arrangements. Sharing the gains would still result in a positive benefit which would still represent a significant incentive for OFTOs to seek out these benefits. This concept can be compared to the availability incentive for the OFTO where they do not face the entire risk of an outage but are still considered to have enough incentive to act in a desirable and revenue maximising manner.

We note that the 20 year revenue stream is a significant amount of time in which the OFTO would have the opportunity to gain from refinancing.

Section 10

Do you have comments on the practicality of the potential options for dealing with the future developments outlined?

The issue of what occurs at the end of the revenue stream is considered a critical one by Centrica as prior to progressing with a project we need to make assumptions of our expected future costs. Centrica would expect that at the end of the 20 year revenue stream that costs should only include operation and maintenance. It would be desirable to avoid the need for re-tendering for short extensions.

In relation to requests to upgrade or expand capacity, it is not clear (perhaps due to the values used in the example in the first bullet in 10.10) that this would only be in relation to capacity increases up to the 20% limit.

Centrica would like to reiterate our thanks to Ofgem for conducting this consultation and providing the opportunity to comment.

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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