

DONG Wind (UK) Ltd
33 Grosvenor Place
Belgravia
London
SW1X 7HY

Tel +44 (0)20 7811 5200
www.dongenergy.com

12 February 2010

Sam Cope
Policy Manager, Regulatory Regime Development
Ofgem 9 Millbank
London
SW1P 3GE

Dear Mr. Cope

Offshore Electricity Transmission: Consultation on the Enduring Regime – DONG Energy's Response

Thank you for the opportunity to comment on the consultation to further define the OFTO Enduring Regime. DONG Energy, whose comments we are putting forward here, recognises the importance that the enduring regime will have for the development of the offshore wind business in UK waters and for the achievement of the Government's 2020 target. Since the first enduring tender process is scheduled to start in summer 2010, there is an urgent need to develop the regulation in a fair, clear and efficient manner. This will facilitate the process and provide confidence to the offshore investors that the proposed approach will deliver the transmission assets needed for their projects in an efficient and timely manner.

As we have stated in our responses to previous consultations and letters on the OFTO regime and we repeat in this response, we have some suggestions for improvements to the current proposal for the OFTO enduring regime. We believe that the proposed regulation involves excessive costs, time and risks for all parties involved in the process. We are of the opinion that the complexity and uncertainties it creates may delay many offshore wind projects currently under development and that it may jeopardize the Government's ambitions for deployment of offshore wind towards 2020. Therefore we suggest the following main issues to be addressed in the design of the OFTO enduring regime:

- *Generators should have the opportunity to build the offshore transmission assets*

One of our main objections to the proposed system is the lack of flexibility. We believe that developers should have the flexibility to be able to design and construct the offshore transmission assets before handing them over to the appointed OFTO. Relying on the proposed enduring OFTO tender process will likely cause costly delays for projects that do not make the second transitional OFTO process and will have to wait for the first offshore transmission connection contracts in the enduring regime to be placed. Specifically, this will be an issue for Round 1 and Round 2 extensions that will need to be developed in a tight timescale and be in operation by the end of 2016. We believe this will be extremely challenging and hardly achievable without the introduction of more flexibility into the currently proposed enduring regime.

- *Stronger incentives for OFTO for immediate repair of connection required*

In case of a failure of the OFTO assets, or reduced availability, we strongly believe that the OFTO should not only be incentivised, but also required to repair the failure as quickly as possible and not, as currently proposed, at a time of the OFTO's choosing. A generator will have no alternative way of exporting the electricity: this will cause a substantial loss of income for the generator and the economy as a whole will miss out on much needed carbon free electricity produced at limited operational costs. As it would be difficult to enforce the requirement to repair transmission asset failures as quickly as possible, the regime should also incentivise the OFTO strongly for immediate repair. Penalties for the OFTO in case repair time is prolonged should not be limited to only 10% of its annual revenue stream. We would recommend removing the cap on the penalty in order to align incentives between the OFTO and the generator. Furthermore, we believe - in the interest of fairness - that the reductions in the OFTO's revenue stream should be equally offset in the generator's TNUoS charges in order to at least partly compensate the generator for its loss of income.

- *Developer Involvement in OFTO Selection*

The OFTO should have the opportunity to introduce innovation and changes, e.g. variant bids, into the tender process. However, these should not be at a risk of delaying the generator development programme. For this reason, we suggest that this aspect should be one of the parameters in the assessment of the different OFTO bids and that developers should take part in the bid evaluation with respect to this element.

Please find more details on the abovementioned issues and other comments to the consultation in the sections below.

Section 2 - The open letter on the enduring regime

As stated in our previous consultation responses and in the response to the November letter, we consider that flexibility for developers, with regards to design and construction of the offshore transmission assets, should be one of the main elements for the definition of the enduring regime. Requirements for timely, economic and efficient delivery of the Round 3 projects (timescale, size of the projects, supply chain commitment, etc) are different from those for the Round 1 and 2 project extensions and both differ from that needed by later Round 2 projects.

For this reason we recommend a more flexible solution, where developers can choose to design and construct the offshore transmission assets before handing it over to the appointed OFTO. Such a solution should be put in place together with the proposed "early" and "late" OFTO appointments. Considering that many developers and suppliers are in favour of this approach, we have found paragraph 2.6 in the consultation quite disappointing, where it is stated that "*Several developers requested that the transitional arrangements be put in place on an enduring basis. This is not within the scope of this consultation. The Government has previously decided that, under the enduring arrangements, the OFTO will be responsible for the construction of offshore transmission assets.*". We would have expected more detailed arguments including the reasons why Ofgem does not intend to implement the more flexible solution, given the significant interest that industry has shown, and not a generic reference to an earlier Government decision.

Section 3 - The connection application process

We generally agree on the two-stage connection application process proposed in the consultation and we do not have any further comments on that. However, we are concerned about the potential additional costs that Stage 2 will imply. Will the generator have to pay additional fees for this second application to be processed? If the OFTO will have to directly apply for this second stage, we assume that it will be allowed to recover its costs via the revenue stream with a consequent increase of total costs.

DONG also acknowledges the needs of securing the costs of connection works by the generator, in order to provide financial security to both NETSO and OFTO, and appreciates the fact that Ofgem recognises that these costs will be higher in the enduring regime. We would therefore suggest Ofgem to closely work with NGET in order to develop a user commitment system that will not imply too high costs for developers with a consequent risk of delaying projects

Section 4 - Triggering the tender process

DONG considers qualifying pre-conditions and tender entry conditions sufficient for the proposed regime, although where you say "The developer has entered into a Crown Estate lease" we assume you mean that "The developer has entered into an agreement for lease with the Crown Estate" (ie not the lease itself, as per the current tender regulations). Further, we would like to evaluate the standard pre-construction works agreement form before expressing any final opinion on that: we consider it to be an useful tool to deal with transfer pre-construction works, but on general terms, we think that project specific forms are normally more fit-for-purpose and we would prefer this type of solution. Besides, this form should be developed based on bilateral discussions between developers and Ofgem. We are therefore available to cooperate with Ofgem to provide input for its definition.

We also consider that the possible requirements that "the developer's project has an energisation date which is with[in] a fixed number of years from the developer's date of application to the tender process" would mean an additional hurdle on the generator and we do not see any reason behind it. The generator is already highly incentivised in maintaining its programme through the agreement signed with The Crown Estate and, in some cases, the pre-conditions to enter the ROC regime on a 2-ROC band. Therefore, we do not see any advantage in adding this further requirement.

Regarding triggering the tender window and its timing, we consider that the developer should ultimately be responsible for it, since it is aware of the status of the development. Tender windows can represent a suitable tool for coordinating bid evaluation process and for saving some administrative costs. However, they do not necessarily provide a greater opportunity to coordinate requests for capacity (section 4.11): this is true if projects that can be coordinated seek for an OFTO in the same tender window. This advantage is lost if applications are made in different years since it may lead to the appointment of different OFTO which may not necessarily cooperate.

The two proposed timings of OFTO appointment provide a discrete level of flexibility to developers for the development of their projects and we consider both to be necessarily included in the regime. However, we consider the "late" appointment adds an additional risk on the developer and not only on the OFTO, since some of the consents and preconstruction works will be based on design exercises, e.g. consent for the offshore cable to shore. In this case, it is not clear from the consultation if the appointed OFTO would be

able to propose a completely new approach which will require additional consents and potentially some new works to replace those made during pre-construction. This might include pre-construction works by NGET where it is important to progress onshore works based on assumed offshore works. Even though the generator will be able to recover pre-construction costs from the OFTO, these additional works will add to the risk of the project being delayed and would not be preferable by the developer. There should be a regulation to define how much pre-construction works can be changed and performed again by the appointed OFTO, especially in light of the generator programme for the development of the site. In addition, it is considered that any decision by Ofgem about the preferred OFTO should take into account sunk costs which have been progressed in good faith by the developer in meetings its development timescales.

As previously mentioned, we consider that in order to have a flexible range of possible solutions, developers should in the enduring regime be allowed to choose to design and construct the offshore transmission assets before handing them over to the appointed OFTO. This solution will facilitate the delivery of those projects which are already at an advanced stage, e.g. late Round 2 projects, or which need to be fully operating at an early date, e.g. Round 1 and 2 extensions to be fully operating by 2016.

We would like to stress once more that, especially for these extension projects, it will be extremely challenging to include the current OFTO regime into their development programme and there is a great risk that the OFTO tender will delay these installations. An early OFTO appointment is not possible: developers will need to start environmental surveys in Q3 2010 and even if an OFTO tender process is triggered in 2010, an OFTO will not be in place before Q3/Q4 of 2011. This means that most of the consenting works will need to be made by the developers and therefore any advantage of an early appointment will be lost. A late OFTO appointment is also not possible, due to the tight schedule that developers need to follow between receiving consent and starting construction. An OFTO who will build the offshore asset will need to be in place in time to design and deliver the offshore transmission asset so that the offshore wind farm can be fully commissioned by 2016. Unless Ofgem relents on this point, the only option would be to tender and then appoint an OFTO before consents have been obtained (or even before consents have been submitted) in order to have it in place at the right time. This approach will clearly add great uncertainty to the bidders, since they will have no certainty on the consentability of the projects.

We consider that bids based on core and contingency costs can represent a suitable solution to reduce uncertainty into the appointment process, especially for the early OFTO appointment. It is difficult to define at this stage which costs should be considered as contingency and we appreciate the proposed flexibility in the definition of which elements should be included, but we consider that generators should provide some inputs, according to the results of the pre-construction works that have been made. We have no preferred approach on who should define those elements.

DONG is also in favour of defining pre-construction works on a case-by-case basis, due to the different projects that the regime will look at.

We would also comment on the proposal of making all data gathered during the pre-construction phase available in the data room (paragraph 4.30). On the one hand this solution may mitigate competition concerns, on the other hand it may reduce the ability of developers to perform pre-construction works, since potential OFTO bidders or suppliers who are asked by generators to participate to this phase, may not want to share some of their confidential information with their competitors.

Section 5 - The scope of the tender

DONG agrees on the general terms proposed for the definition of tender specifications and considers both grid application information and results from pre-construction works important elements to be included in the specifications. Besides, we would suggest the possibility of including additional information that have been collected after the tender process has started, e.g. PQ stage. This would allow the developer to proceed with other pre-construction works during the first stage of the tender process and facilitate the moving forward of the development.

We also are in favour of allowing bidders to have flexibility in their bid, even though we would suggest bidders are required to describe reasons/advantages/drawbacks behind the proposed alternatives. We consider this to be a relevant aspect to facilitate the evaluation of the bids.

DONG do not agree with the proposed approach for incorporating capacity oversizing into the enduring regime. In our view, the proposed solution will mainly lead to point-to-point connections and reduce the effectiveness of the proposed regime. It is essential that a mechanism is put in place for a strategic and efficient development of the offshore grid (which we thought was one of the reasons behind the development of the whole OFTO regime). Ofgem needs to accept that consumers will have to bear some risks in order to achieve this objective. In some cases, e.g. use of HVDC links, the possibility of upgrading the installed capacity is very limited, i.e. a new asset needs to replace the existing one, and an initial oversizing will be definitely preferable and given the extent of offshore development foreseen by the Government it is surely important to factor this into development of the infrastructure. Moreover, since this approach will facilitate the development of the grid and consumers will as well benefit by this, we do not see why they should not bear some of the risks that this approach has. Leaving joint development to individual developers, or by chance, projects coming together in the annual tender rounds is simply not going to produce the desired results.

Section 6 - Facilitating competition

We consider that facilitating new entry should not be included in the enduring regime. As mentioned in the consultation, the allocation of slots for new entrants may affect the competitiveness of the tender process and reduce or distort the bidding phase. Moreover, as developers, we would rather have a reduced pool of capable OFTO to potentially bid for our projects than a broader range of possible bidder to increase the market competitiveness, but without the necessary capability to deliver and operate the transmission asset.

Bidding on indicative costs can be an interesting solution that needs further evaluation. However, we think it risks adding uncertainty to bidders and also to developers. After the OFTO has been appointed according to indicative costs (to be included in the bid), a tender contracting phase will need to follow. This phase may take longer than if the discussions were made to obtain a firm offer and this may represent an issue, especially for those projects at an advanced developed stage or for Round 1 and 2 extension projects where an aggressive development programme needs to be determined.

Section 7 - Tender timings

We acknowledge the effort that Ofgem has put in reducing the steps of the tender process and increase the length of it. We consider the PQ phase to be sufficiently long to promote a detailed shortlist of potential OFTO. We are still a little bit concerned about the length of the ITT process. Especially for large installations, e.g. HVDC links, it may be possible that

longer timing will be necessary to design the transmission asset. We suggest to consider a flexible length of be used for this phase, with timing deciding before the tender starts and dependent on the size of the installations and the complexity of the design (this information can be defined according to the grid connection offer that the developers will put in the data room).

In paragraph 7.4, we would like to include O&M in the list of capabilities that bidders need to demonstrate for the PQ phase together with design and construction (second bullet point).

Section 8 - Bid evaluation

We consider the developer to have a fundamental role to play in the evaluation of the bid. Especially in case of late OFTO appointment, where the developer has already performed a set of pre-construction works, variant bids can represent a risk for the development of the site. It can be envisaged that developers have programmed their development according to the pre-construction works: variant bids may affect this and cause serious delays, especially if some of the pre-construction works will need to be made again. Moreover, developers should have some certainty that the pre-works will be acknowledged in the bid process and should be guaranteed that proposed variant bids will not cause major delays to the project.

We would also suggest that proposed variant bids should be evaluated based on their advantages/drawbacks compared to the other proposed solutions. Generators should be part of the evaluation of these bids which should be assessed against the timescale for the development of the site. Moreover, bidders should present them in terms of priority based on their assessment, i.e. which variant bids may be the most suitable for the site and for which reason, and reduced these bids to those that can efficiently deliver the assets without interfering with the development programme of the site.

Transmission losses are an important aspect to be assessed in a bid evaluation: however we see as very challenging to define them in case of an early OFTO appointment, when bidders need to face more uncertainties for the definition of revenue stream. Regarding the "Clarification of transmission losses" open letter, we do agree that OFTO needs to optimise the asset in order to reduce losses and costs. We do not have currently a preferred solution to address this issue in the tender process, but we appreciate that bidders should be incentivised to reduce them. We note however that developers will be concerned about paying excessive costs (in the form of TNUoS) for investment in assets which reduce losses (that are socialised), this is clearly different to how it works onshore in respect of local circuits.

Finally, we consider that an OFTO as last resort needs to be put in place also for the enduring regime. Running a second tender process may lead the process to a very large delay that can sensibly affect the delivery of wind farms and the achievement of the renewable targets. We would therefore suggest an approach where, once the first tender process has not produce any OFTO appointment, the developer is allowed to design and build its own asset and then to run a tender process with which appoint an OFTO to which hand over the commissioned asset. This approach would be based on the same assumptions proposed for the third option for OFTO appointment as mentioned before in this response, i.e. the developer design and build its asset and then hands it over to the appointed OFTO. We consider this solution for OFTO as last resort to be the least dangerous for the development of the site and the one that can add the least amount of risks.

Section 9 - The revenue stream

Regarding the revenue stream, DONG has previously made the point that awarding this for 20 years is inconsistent with the approach taken onshore where costs are amortised over their own asset life, rather than an arbitrary figure that is more related to the generators asset life. Moreover, we do not understand how this will work when the revenue stream relates to a transmission asset built for a phased/staged project (paragraph 9.5 in the consultation material). Assuming a two phased project to be built in 2 years where the first part of the transmission asset will be available by the end of the first year and the revenue stream for this part will be paid from this date. In the second year, the second part of the project is energised through the second part of the transmission asset that have been completed and the second revenue stream will start to be paid. How will the end of the revenue stream be calculated in this case? Will there be a phased re-tendering at the end of the respective 20 years or will the period for the revenue stream be based on the first project only (in which case the second revenue stream is based on 19 years) or on the second phase (in which case the first revenue stream is based on 21 years)? A more reasonable approach would be to award the revenue stream for 20 years from the commissioning of the last phase of development, even if this means that the first has, for example, 22 years.

We would also like to comment on regarding the availability incentive mechanism that has been proposed for the transitional projects and that Ofgem plans to apply to the enduring regime (section 9.17 in the consultation document) without any amendments.

First of all, considering the cost recovery for the OFTO as stated in paragraph 26 of the OFTO Special Licence Conditions, it is not clear how the OFTO will be able to recover the costs defined as Temporary Physical Disconnection Terms. Would these costs be included into the residual charges and therefore socialised among all parties in the system? Or will it all be charged on the generator connected to the asset?

DONG Energy has been in correspondence with NGET regarding the way in which an OFTO revenue stream is translated into the TNUoS charge and in particular how any penalty imposed on the OFTO by way of lower revenue stream feeds back into a lower TNUoS. We were rather surprised to hear from NGET that it does not, and that any reduction in revenue would in fact benefit all users of the transmission system by way of the "residual charge". Is this how Ofgem understand the arrangements and was this truly what was intended?

Another of our concerns regards the fact that the OFTO is not strongly incentivised to repair a failure as soon as possible. We are afraid that the current design will imply that repairs may be delayed as the cost imposed on the OFTO as a consequence of the delay is likely to be insufficient to match the potential reduction of repair cost if the repair time is extended. However the generator which uses this asset will face a significant additional loss of income if the time spent on repairing the connection is extended, and would have no way to control this.

This can be visualised in the following indicative example, which does not represent any existing situation and is calculated according to the tool provided by Ofgem to assess how the incentive mechanism works. We assume a serious failure of the offshore transmission asset which lasts a minimum of 3 months (starting on the 1st February in year 3). The OFTO has three options to repair it (please note that all costs are indicative and with the only purpose being to provide this example):

1. Within three months, with a cost for repair of £5m
2. Within four months, with a cost for repair of £4m

3. Within six months, with a cost for repair of £2m

The chart below (figure 1) presents the variation of the OFTO revenue stream for 20 years for the three options, as calculated with the proposed tool, together with the revenue stream when no failure occurs during the 20 year lifetime of the asset (blue line), i.e. maximum revenue stream for the OFTO. Area A (pink) represents the loss in the OFTO revenue stream that will occur if the OFTO decides to repair the asset in four months (option 2 above) instead of three months (option 1), whereas area B (dark red) indicates the additional loss if six months (option 3) are used to repair the asset.

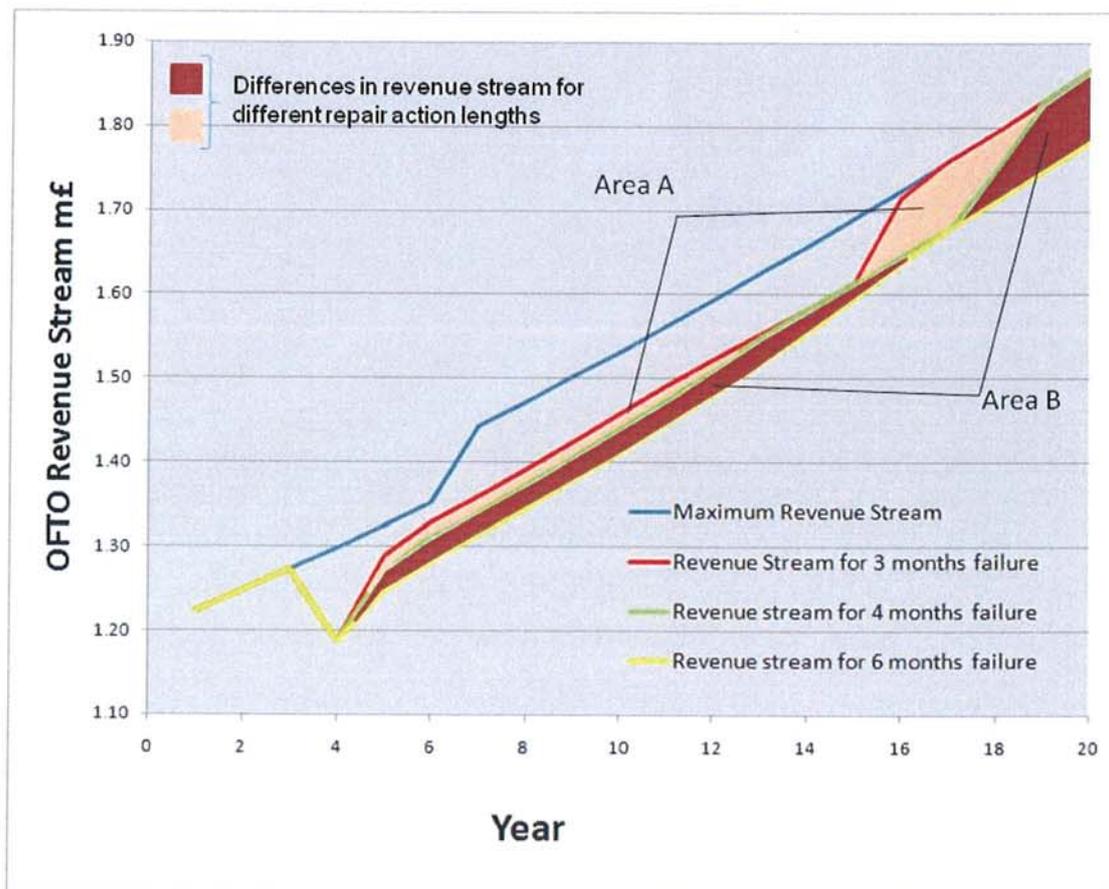


Figure 1

With this information the OFTO can choose the solution which will have minimum financial impact on its business, i.e. if area A+B is smaller than £3m (the total loss of 20 year revenue stream is smaller than the difference between the cost of three months repair action and the cost of six months repair action), the OFTO is likely to use six months to repair the asset, leaving the generator for a longer time without the ability to transmit the power and therefore to generate income. We consider this to be a possible outcome if the incentive mechanism is implemented in its currently proposed form.

We believe that this approach is dangerous and – if implemented - would impose a substantial risk on the generator's business. We understand that the OFTO's business should not be put at risk either, but the incentive mechanism should push the OFTO to choose the fastest possible repair action in order to avoid substantial losses for the generator and unnecessary reductions in renewable electricity production. This can be

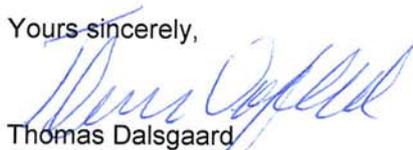
achieved with a penalty which is higher than the proposed 10% of the annual revenue stream. A higher penalty which is targeted not only on the size of the failure, but on its duration will definitely represent a more serious incentive for the OFTO to repair any failure at the earliest opportunity.

As stated in our response to the special license condition letter, we have a number of other issues with the proposed incentive mechanism. We will not repeat the issues in this consultation response, but would like to point out that they are still relevant and need to be addressed in the transitional regime as well as in the enduring.

Responding to future developments

No comments.

Yours sincerely,



Thomas Dalsgaard

Vice President, Regulatory Affairs

DONG Energy Power A/S
Kraftværksvej 53
7000 Fredericia
Denmark

Telephone: +45 99 55 11 11