Preferred bidders
Other interested parties

Promoting choice and value for all gas and electricity customers

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Date: 13 October 2010

Dear Colleague,

Open letter regarding alternative credit rating arrangements for new offshore transmission owners ("OFTOs")

1. Standard condition E11 'Credit Rating' (the "Condition") of the electricity transmission licence (the "Licence") requires licensees to maintain at all times an investment grade issuer credit rating[1] or, with the prior written permission of the Authority, any such alternative arrangements proposed by the licensee as the Authority considers appropriate.

2. The April 2003 open letter[2] on the regulation of new IDNOs indicated that Ofgem would develop financial ring fencing arrangements that would allow a financially stable smaller company to comply with these obligations. That document sets a useful reference point for considering how the licence condition should apply to OFTOs.

3. Ofgem has received requests from preferred bidders for permission to apply alternative arrangements to satisfy the Condition. Ofgem has considered whether there might be alternative arrangements that would better suit the circumstances of smaller companies and would also protect the interests of consumers. Alternative arrangements are set out in annex 1 and illustrated in annex 2.

4. The alternative arrangements outlined in annex 1 are thought to better suit the circumstances of OFTOs by providing a proportionate and practical way of achieving the policy aims of the credit rating condition[3] which is consistent with the arrangements onshore whilst adapting to suit the particular circumstances of the OFTOs. These alternatives have also been informed by proposals received from preferred bidders.

5. In particular instrument credit ratings are not mentioned in the licence but may be relevant to OFTOs because there is an expectation that they will be financed by senior debt and not by bonds. An instrument credit rating mirrors the requirements of an issuer credit rating but is based upon the senior debt on a company's balance sheet rather than the bonds in issue. The differences between instrument and issuer

[1] As defined in standard condition E11 of the Licence
[2] See http://www.ofgem.gov.uk/Networks/ElecDist/Policy/IDNOs/Documents1/3057-april16_letter.pdf
[3] As set out in the Review of the 'Ring Fence' Conditions in Network Operator Licences – see http://www.ofgem.gov.uk/Networks/Policy/Documents1/IA_Ring_Fence_Review_3%20Mar%2010_final.pdf

ratings have been considered and the impact they would have, for instance on an OFTO's ability to access bond finance, has been considered in preparing this outline of potential alternative arrangements.

6. These alternative arrangements are indicative only and do not prevent preferred bidders or licensees proposing new alternative arrangements which the Authority will consider on their own merits. Each OFTO will need to propose alternative arrangements for the Authority to consider consenting to if they wish to make use of any of the options outlined below.

7. In order for any alternative arrangements to constitute licence compliance a licensee would need the Authority's written consent and Ofgem may request draft copies of any agreements (keep well[4], escrow, on demand bond, letter of credit) as part of the process when considering the application for alternative arrangements.

8. Cash operating costs are projected operating costs for six months as agreed with Ofgem on a six monthly basis and include asset replacement costs but are not intended to include interest payable or repayment of debt. Note however that this is indicative only and may change upon consideration of the facts and circumstances of a particular applicant. Please note that a pro-forma is attached to indicate the likely form of the reporting requirements and to give further guidance on the costs which are to be included.

9. Preferred bidders are asked to contact Ofgem via the transactions email address at offshoretransactions@ofgem.gov.uk no later than 20th October 2010 with specific requests for alternative credit rating arrangements if they are sought.

10. If you would like to discuss any aspect of these arrangements then please do not hesitate to contact Dan Rock, Senior Manager, Financial Analysis (Tel: 0207 901 1815).

Yours faithfully

Stephanie McGregor
Director, Offshore Transmission

[4] A keep well agreement is a legally enforceable undertaking from the parent company that it will provide such financial support as is necessary to its subsidiary for the term of the agreement.

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Annex 1: Alternative credit rating arrangements which the Authority considers are likely to be suitable for OFTOs[5]

Option 1

1. If the parent company does not have an investment grade credit rating then the licensee must maintain:

   i. A keep well agreement with the parent company of the licensee such that the parent company provides a legally enforceable undertaking to provide cash to the amount specified below,

   and

   ii. Cash in escrow, on demand bond or letter of credit with a third party such that the licensee is the recipient of the funds when called. The amount of cash to be available to the licensee under any of these arrangements is specified below. In the case of an on demand bond or letter of credit the counterparty providing the guarantee must hold at least an A- credit rating and be resident in a country with at least an A credit rating.

2. The amount available to the licensee under both i. and ii. above should be no less than six months' cash operating costs and six months' asset replacement costs as reported to the Authority every six months on the pro-forma supplied.

3. The trigger event for drawing down the escrow account or calling the bond or letter of credit will be a failure by the parent company to meet a call under the keep well agreement. The licensee is required to notify Ofgem as soon as a call is made on cash reserve (e.g. monies held in the escrow/bond/letter of credit), and in any event no more than 24 hours after the call is made. As soon as the escrow account/bond/letter of credit is wholly or partially drawn the parent company will be obliged to arrange for full re-instatement of the escrow/bond/letter of credit and must notify Ofgem each week that elapses without sufficient funds being in place.

Option 2

4. The licensee shall use all reasonable endeavours to ensure that the licensee maintains at all times an investment grade instrument credit rating.

5. For the purposes of this arrangement the instrument credit rating must be provided by a rating agency approved by the Authority[6].

6. Subject to the following paragraph, an investment grade instrument credit rating is as defined in the Licence.

7. Should a higher rating be specified by the rating agency in question as its lowest investment grade credit rating then that higher rating is to be taken as the relevant investment grade for the purposes of this alternative arrangement.

Option 3

8. The licensee must maintain a keep well agreement with the parent company of the licensee such that the parent company provides a legally enforceable undertaking to provide cash to the amount specified below and that parent company must itself

[5] Note that this does not fetter the Authority's right to consider alternative arrangements or refuse particular applications for alternatives which are not considered appropriate when considering the facts of the situation.
[6] For example S&P, Moody's and Fitch are all mentioned in the Licence but the Authority's approval would be needed when implementing alternative arrangements and this would extend to approving that the agency in question is appropriate.

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have an investment grade credit rating (either issuer or instrument based).

9. The amount available to the licensee under the keep well should be no less than six months' cash operating costs and six months' asset replacement costs as reported to the Authority every six months on the pro-forma supplied.

10. In the event that the parent company fails to meet a call under the keep well agreement the licensee is required to notify Ofgem, and in any event no more than 24 hours after the call is made, of this event. As soon as the keep well is wholly or partially drawn upon then the parent company will be obliged to arrange for full re-instatement of the keep well agreement and must notify Ofgem each week that elapses without a sufficient agreement being in place.

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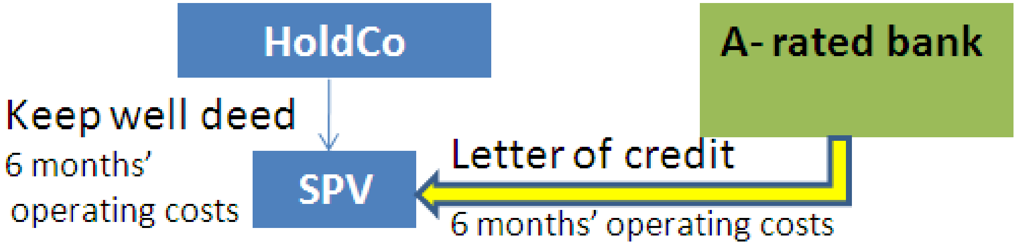
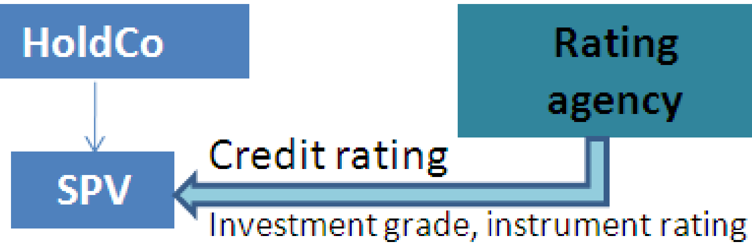
Annex 2: Illustration of the potential alternative arrangements set out in annex 1

Note: These diagrams are to aid understanding only and do not change the potential alternative arrangements set out in annex 1 in the event that any inconsistency is identified.

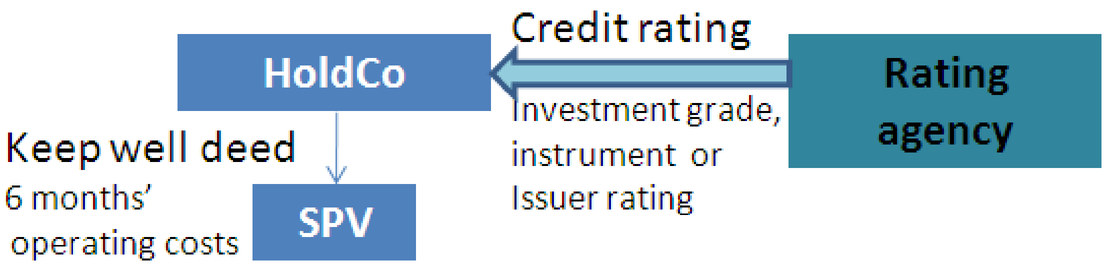
Option 1



Option 2



Option 3



Annex 3: Example reporting pro-forma

OFTO Credit Rating - Alternative Arrangements Data

Licensee Name:		
Reporting Date 15 January 2010:	**6 Months Ending**	
	31 March 2010	**31 March 2011**
	(Actual £)	**(Forecast £)**
Operating & Asset Replacement Costs		
Ongoing O&M		
Reactive maintenance		
Insurance costs		
SPV Management		
Accounting		
Legal		
Licence fees		
Network rates		
Crown Estate lease costs		
Other rates		
Office & Property Costs		
Travel & Subsistance		
IT, Telephony, Printing and Stationery		
Replacement expenditure (not capitalised)		
<Other items expensed through the P&L - over-type>		
<Other items expensed through the P&L - over-type>		
<Other items expensed through the P&L - over-type>		
<Other items expensed through the P&L - over-type>		
Total P&L payments	0	0
Existing network assets - repair/replacement (capitalised)		
Escrow / Guarantee Amount (£)	0	0

Memo items

Finance costs (net interest payable)		
Tax		

Current arrangements in place to satisfy escrow requirement with expiry date and renewal details:

Please note: Ofgem may require original documentary evidence of the escrow / guarantee arrangements described above