

All with an interest in offshore
electricity transmission

*Promoting choice and value for
all gas and electricity customers*

Direct Dial: 020 7901 0532

Email: sam.williams@ofgem.gov.uk

Date: 14 July 2011

Dear Colleagues

Version 1.1 of the draft generic Offshore Transmission Owner Licence

We have today published version 1.1 of the generic Offshore Transmission Owner (OFTO) Licence. This updates version 0.7 of the generic OFTO licence based on the recent consultation on the availability incentive and lessons learnt from the first transitional tender round (TR1). This letter summarises these changes. We have also made some minor housekeeping changes which are not detailed in this letter but are shown in the revision history of the licence.

We have also issued an updated guidance note and illustrative incentive model to aid understanding of the licence. These documents support version 1.1 of the generic OFTO licence and provide explanation and clarification on the detailed mechanisms in the licence. If there are any discrepancies between these documents, the licence takes precedence.

Version 1.1 of the generic OFTO Licence applies to the first tranche of the second transitional tender round (TR2a) only. The project specific licences developed for TR1 projects still apply to those projects.

Consultation on changes to the OFTO availability incentive

We issued a consultation letter on the availability incentive for TR2a on 28 March 2011¹. We set out that we do not intend to change availability targets or the level of revenue at risk. We confirm that in TR2a availability targets will be set at 98 per cent and up to 50 per cent of annual OFTO revenue will be at risk (spread over several years).

We also proposed a number of potential changes and refinements. We held a workshop to discuss initial views on these changes and lessons learned from TR1. A link is provided to the slides from that workshop which includes a summary of the technical analysis conducted by Sinclair Knight Merz into availability targets². You can find responses to the consultation letter on the Ofgem website. A summary of responses is attached at annex 1. In the consultation letter, we discussed the following issues:

Simplifications

We proposed two simplifications to the availability incentive. Please refer to the consultation letter for more details. These were:

¹ [Changes to the Offshore Transmission Owner \(OFTO\) availability incentive](#)

² [Presentation from the workshop on the OFTO availability incentive](#)

1. Removing variable monthly targets in favour of a flat annual target; and
2. Removing the credit banking mechanism and applying credits at the same time as penalties.

Responses were supportive of the proposed simplifications. We consider that these simplifications meet the policy intent by sharpening the incentive and ensuring that there is no double counting of the weighting mechanism. We have therefore applied them in version 1.1 of the generic OFTO licence.

Maintaining the incentive

We asked how we can best ensure that OFTOs face the same incentive throughout their 20 year revenue stream. In TR1, we included a performance bond in the licence to make sure OFTOs can cover penalties in the later years of the revenue stream. Some respondents suggested maintaining the performance bond with additional clarity. Others suggested a requirement on the OFTO to hold an operational reserve.

We intend to maintain the performance bond in TR2a. We have provided additional clarity on the purpose of the bond and the situations under which it might be called in the licence guidance note. In summary, it ensures that the OFTO will meet availability penalties and obligations in the latter years of its revenue stream. Any financial payments relating to the incentive not met at the end of the revenue stream would be paid for out of this bond. The remainder is returned to the OFTO.

Commissioning

Some bidders asked for clarity about whether the incentive is active during the testing of assets at full generation capacity. We set out that we consider that the availability incentive should apply from asset transfer. Respondents agreed with this proposal, so we are not changing the point from which the incentive applies.

Timing of payments

The consultation discussed aligning the period in which credits and penalties are earned with the period in which they are paid. Although there was general support for aligning payments, a number of respondents suggested that this may be too complicated to justify a change. Therefore we do not propose to alter these arrangements.

Information flows

We also discussed the flow of information between OFTO and developer regarding outages, which is currently managed through industry codes. Some developers suggested that there should be a direct flow of information. However, a number of respondents said that it was too early to comment as we have not yet seen how the current arrangements work in practice. We do not intend to make any changes at this time but we will continue to consider the existing arrangements in light of future developments and experiences.

Lessons learnt

In the consultation we also set out that we intend to make a number of changes to other licence conditions for TR2a based on lessons learnt from TR1. These changes are detailed in the revision history of version 1.1 of the licence. In addition to this, we also intend to implement the following change:

Indexation

We have seen through the TR1 ITT and close process that OFTOs may enter into RPI swaps to hedge against inflation rate volatility. The RPI swap market is not significant and banks are not used to the indexation approach used in the OFTO licence. Usually, banks enter into

swaps on Public Private Partnership (PPP) or Private Finance Initiative (PFI) deals, which use a different form of indexation to OFTOs. We have received feedback that banks are less comfortable with the previous approach used in the OFTO licence than the PPP/PFI approach. Although we have appointed an OFTO on this basis, this approach could mean that swaps are more expensive, which would lead to higher costs for consumers.

We have been advised that changing to a different approach to indexation could lead to a benefit of 2-3 basis points on the swap rates, which would pass through to consumers.

We have adopted a modified indexation approach for TR2a. This is linked to a single point rather than yearly average. In the TR1 OFTO licence, we took the percentage change from one year to the next based on the average of RPI from January to December. PPP/PFI structures are usually linked to a single point (e.g. September to September). Therefore indexation applied each April will be the percentage increase in RPI from September two years previously to the previous September. Using September will mean there is firm information for setting charges.

OFTO of Last Resort

Through the consultation and workshop, stakeholders questioned the process for enforcement action and appointing an OFTO of last resort if an OFTO significantly underperformed. We recognise the need to provide additional clarity on the OFTO of last resort process to provide certainty to generators, bidders and funders. Therefore we have also published updated OFTO of last resort guidance. We will continue to review and update the guidance in light of experience. The key changes since version 1.0 are summarised below.

1. **Clarity and consistency:** We have made a number of housekeeping changes to improve the clarity of the document. We have also added detail on some of our proposals based on feedback from the first tender round. For example, we discuss how we would determine an assumed asset transfer value for any assets that require an OFTO of Last Resort. We also provide more detail around options other than the OFTO of Last Resort, such as proactive steps to prevent the need for an OFTO of Last Resort, energy administration or an open market sale of the assets.
2. **Developments with enduring regime:** In light of developments on the enduring regime policy, the document is drafted on the basis that the OFTO of Last Resort arrangements would apply where we are unable to appoint an OFTO following a generator build enduring tender process.

Next steps

We intend version 1.1 of the OFTO licence to be the final generic draft for TR2a projects. In the lead up to the financial close and licence grant for these projects we will reflect any project specific requirements necessary in advance of the statutory consultation under section 8A of the Electricity Act 1989 to modify each OFTO licence at grant.

We are also considering changes to the availability incentive for future tender rounds. As part of the consultation and workshop on the incentive, respondents put forward a number of proposals including greater cooperation and the importance of taking generation revenues into account. We welcome these proposals and continued engagement from industry. We intend to explore these and other issues in our further development of OFTO incentive mechanisms.

Should you have any queries questions about the content of this letter, please contact Sam Williams (sam.williams@ofgem.gov.uk or 020 7901 0532).

Yours faithfully,

Robert Hull
Managing Director – Commercial

Summary of responses to consultation on the OFTO availability incentive

Q1 Does removing monthly availability targets lead to a simpler and better targeted incentive?

There was broad support for this simplification proposal, with all but one respondent supporting the proposal.

Q2 Would the incentive better meet its policy intent if we replaced the credit banking mechanism?

All respondents except one supported the proposal to pay out credits earlier as opposed to with a 5 year delay. The one that opposed the proposal did not support a revenue uplift at all. One further respondent supported the simplification proposal but also did not support the revenue uplift, suggesting that OFTOs should not be rewarded for business as usual.

Q3 What are the advantages and disadvantages of aligning availability payments to the end of March?

Although there was general support for aligning payments, a number of respondents suggested that this may be too complicated to justify a change. Four respondents supported the proposal to align payments. However, one of these respondents suggested that the complications arising from aligning the payments to the end of March were too great to justify changing the process. Two respondents did not support the proposal.

Q4 Can we improve the flow of information about outages to developers within the existing industry framework?

Four respondents said they were comfortable with the current information flow process and were confident that the current requirements were enough to ensure effective communication between OFTO and generator. One of these suggested that there may be need in the future to implement changes if the current system does not work as currently planned. Four respondents supported including formal requirements on OFTOs to report directly to generators but one of these felt that the current system may suffice.

Q5 How can we best ensure that the incentive is maintained for the length of the revenue stream?

One respondent did not support including a performance bond or operational reserve requirement in the licence. This respondent suggested instead linking revenue at risk to performance, so that poor performance in one year led to a higher revenue at risk in the next. All remaining respondents supported keeping a performance bond, operational reserve or similar in the licence. A number of respondents requested clarity on the mechanics of calling upon the bond or reserve.

Q6 How can we account for testing of transmission assets during wind farm commissioning?

Two respondents suggested that the availability incentive mechanism should not apply during the commissioning period. All other respondents suggested that the incentive should apply during commissioning. Two respondents supportive of keeping the availability incentive during commissioning suggested the generator and OFTO should be able to agree outage periods where the incentive would not apply.

Further issues

A number of respondents felt that the incentive would be improved by weighting credits and debits according to actual generation revenues. This would be to help encourage effective communication and cooperation between OFTO and generator.

There were a number of requests to clarify the OFTO of last resort and licence revocation process, including clarifying what would trigger licence revocation. They also requested clarity on the process for selecting the OFTO of last resort.

Two respondents suggested including some intermediary steps in the licence for OFTOs that consistently perform below the availability target but before licence revocation, in order to penalise the OFTO for performance below the revenue impact cap.