

## Barclays Corporate response to OFTO Enduring Regime consultation exercise

February 2012

Barclays Corporate, the corporate banking division of Barclays Bank PLC, is delighted to contribute to the Ofgem consultation exercise in relation to the OFTO Enduring Regime. Having supported the OFTO scheme from the outset and led the senior debt funding for the first three OFTO projects to achieve licence award in Transitional Round 1 as well as providing ongoing support for other OFTO projects in TR1 and TR2, we are keen to build on our experience of financing OFTO projects by contributing to this consultation. Our response is primarily aimed at considering the Enduring Regime from a bankability perspective and hence we have focused on headline issues plus specific consultation questions relevant to this.

### Headline Issues

#### Construction Phase Risk

- *Strong preference for single EPC (Engineer Procure Construct) turnkey contract approach particularly for OFTO Build option*
- *Multi-contract construction approach would pose inherently complex financing risks*
- *Licence requirement for investment grade rating a challenge under multi-contract approach*
- *Compensation mechanism in case of construction default*

The inclusion of construction is a key differentiating feature between the Transitional Round OFTO projects and the Enduring Regime. From a funding perspective, our ability to fund a project through its construction phase is something that is familiar to banks through involvement in other infrastructure and energy asset classes such as PFI/PPP and Wind Farm financing.

We understand that to date, construction packages for transmission links have been let on either a single EPC style basis, or on a multi-contract basis. From a financing viewpoint, a multi-contract approach poses inherently complex challenges in ensuring that the construction risk is adequately mitigated including interface and co-operation risks between multiple contractors, consideration of credit risk on multiple counterparties one or more of who may not be sufficiently creditworthy in their own right, and resolution of disputes that may arise between various contracting parties.

Under the Generator Build option whereby the Generator takes on the construction and commissioning aspects prior to the OFTO taking over the transmission asset, this would replicate the approach under the Transitional regime and hence would be acceptable from a funder perspective subject to the provision of adequate post construction warranties/guarantees and the transfer/assignment of relevant rights and agreements.

Under the OFTO Build option, it would be a strong preference of funders to have a single EPC contractor managing the overall contracting process and construction programme such that the OFTO's interface would only be with one entity (of sufficient financial strength and technical experience) in respect of the entire construction works.

Should a multi-contract approach be preferred, then the bankability of a particular project will depend on the level of protection of construction risk that can be achieved through the Licence. In such circumstances funders are likely to expect that crystallisation of risks that are a direct consequence of a multi-contract approach, can be mitigated by adequate risk mitigation cover being provided under the Licence. The issue of interface risk between the Wind Farm Generator and the OFTO will also need to be adequately mitigated particularly by reference to acceptable and well-defined commissioning requirements.

We would also note that the few Offshore Wind Farm generation projects that have attracted project finance bank debt against multi-contract construction phases have been funded on extremely conservative capital structures requiring far higher contingency levels and a much greater proportion of equity capital to mitigate the additional construction risk. Each of these would come at significant extra cost to a project and hence, if replicated for the construction phase of an OFTO Enduring Regime project, would be unlikely to prove a value for money option from Ofgem and ultimately the consumer's perspective.

Construction risk is also likely to be a significant issue for consideration in relation to the Licence requirement for the OFTO to maintain an investment grade credit rating. A multi-contract approach to construction is far less likely to result in the OFTO being able to achieve an investment grade credit rating during the construction period due to the additional risks inherent within such an approach as described above. On the other hand a single fixed price turnkey EPC contract undertaken or guaranteed by an entity with a strong financial standing as well as the relevant technical and project management expertise, is much more likely to be viewed favourably in relation to achievement of a satisfactory credit rating.

The licence will also need to address compensation payable to the private sector where completion has not occurred. This is required in view of the licence regime that prevents lenders from taking security over the assets. Whilst we would expect the financing structure to enable the appointment of a replacement contractor in case of a construction default, such replacement may not be always possible. Non completion may also occur due to reasons beyond the private sector's control. In view of the absence of a revenue stream, it would not be possible for lenders to recover debt and associated financing costs under these circumstances. We would therefore envisage a compensation regime similar to that seen in PFI/PPPs, with different compensation mechanisms applying depending on the reason for non-completion.

### Capital Structure

- *Increased bank regulation (Basel 3) leading to bank capital and liquidity constraints*
- *Particularly severe impact on long tenor loans such as long-dated project finance*
- *Shorter tenor debt structures will be required to fund future infrastructure assets such as OFTO*
- *Construction-only bank debt financing should be strongly considered for OFTO Enduring Regime including configuration of Licence to assist debt refinancing*

Long-dated project finance bank debt has been a key tool for financing infrastructure and energy projects including the Transitional Round 1 OFTO projects. Whilst project finance has demonstrated

its ability to evidence strong credit characteristics for well-structured transactions, since the onset of the global financial crisis in 2008, there has been a much greater focus on regulation of banks, in particular the impending implications of the Basel 3 global regulatory standards on bank capital adequacy, stress testing, and market liquidity risk.

The increased regulatory pressure and constraints on capital and liquidity are being keenly felt with a resultant detrimental impact on the provision of long-term loans. Hence there is now an increasing focus on the provision of more liquid and shorter-term capital instruments to fund the development of future infrastructure and energy projects. There are a number of methods by which such debt structures may need to develop in order to ensure the liquidity and availability of bank debt financing for future OFTO projects including those in the Enduring Regime such as:

- Soft mini-perm financing through the use of mandatory cash sweep triggers;
- Hard mini-perm financing requiring a bullet repayment of debt within a 3-5 year tenor;
- Significant debt pricing ratchets at regular intervals during the Licence term to incentivise near-term refinancing;
- An ability to re-price project finance bank debt at regular intervals to better reflect the changing cost of capital over time;
- Construction-only bank debt with guaranteed or protected capital take-out/refinancing.

We would strongly suggest Ofgem considers how the above options might fit into the Licence framework for OFTOs in the Enduring Regime, and in particular how the Licence framework may be able to include partial or full refinancing protections to assist the bankability of projects during the Enduring Phase. It is worth clarifying that the use of any of the debt structuring options stated above is not expected to have an adverse impact on the ability of OFTO projects to achieve required levels of debt leverage.

A particular approach that we believe merits strong consideration is to promote the use of bank debt to provide construction financing for the OFTO projects, with a guaranteed take-out or refinancing of debt through the use of institutional or other capital. Banks are well-versed in assessing, understanding and analysing construction risks and hence financing the construction phase of an OFTO through the provision of project finance bank debt would appear to be a logical step. Following this, the stable and certain cashflows that should be generated by an operational OFTO performing well, are potentially extremely attractive to a much larger marketplace of potential investors including pension funds and insurers, who will be interested in providing long-term capital against the Licence term, subject to the OFTO then being able to evidence a strong investment grade credit rating.

## Specific Responses

**Q3.14:** What are your views on our proposed treatment of risk relating to:

- delay to licence grant?
- weather delay?

In the case of proposals for the treatment of delays, both licence and weather related, funders will require additional clarity from OFGEM in respect of the following:

- Will 100% of the cost increases resulting from licence grant delays beyond the price validity date be passed through? What (if any) cost items to be excluded?
- Where delays to either the construction programme or the licence grant are linked to inadequacies with the sub-sea specification survey and no separate sub-sea survey has been carried out by OFTO, will the costs incurred (for both funding and contractual terms) be fully passed through under the TRS?
- Will the proposed “allowable” days for “weather-related delay” be independently verified? What is to stop bidders from underestimating the probability and impact of weather related delays to the construction schedule in an effort to be more competitive during the tendering process? For this reason we would suggest that all bidders be asked to assume the same amount of allowable days when pricing their proposals;
- What are the licence implications in the event that the weather related delays exceed the “allowable” delays? Given that the impact associated with weather risk is beyond the control of the OFTO, we would expect full relief by way of a pass through under the licence to ensure that base case debt tenor is preserved.

**Q3.15:** Are there other areas of risk which would be more efficiently managed (for consumers) through a risk sharing mechanism rather than factored into bidders’ TRS bids? If so, can you suggest how these risks might be shared?

- In keeping with the principles of the Transitional Regime, we expect that the risks associated with planning, consents, licences, permitting, wayleaves and crossing agreements will not reside at the OFTO level. Uncertainty in respect of these risks ahead of asset transfer would make it extremely challenging to provide senior debt funding for the acquisition, particularly in the absence of an appropriate pass through mechanism under the licence.
- Given the multi contract framework and interface risk associated with offshore construction, we would expect that any delays (and resulting cost implications) to the OFTO construction programme caused by 3rd party actions, would be a pass through item under the licence. As previously alluded to, funders would anticipate that this also extends

to time and cost increases resulting from the sub-sea survey. This should also extend to delays due to OFTO's inability to commission the cables where the windfarm is not operational.

**Q3.17:** Are there any aspects of the current transitional arrangements or within the proposals for OFTO build, including revenue term, bid requirements and risk profile, which may prevent access to certain sources of finance in the enduring regime?

- With the anticipated impact of Basle 3 on long term bank finance, the OFTO licence and regime will need to be suitably equipped to enable funding on both a short and long term basis.
- Whilst project finance banks are best equipped to assess, understand and structure deals with a view to mitigating risks during the construction phase under the OFTO build proposal, the liquidity and capital constraints associated with providing senior debt over the long term will act as a major constraining factor in the availability of long-dated commercial bank debt for such projects in the market going forward.
- In the absence of a licence mechanism to provide refinancing certainty, lenders will look to incorporate more costly structural incentives on the borrower such as:
  - a) Soft mini-perms through the use of cash sweeps;
  - b) Significant day-1 margins and ratchets over the life of the licence; and
  - c) Hard mini-perms with a bullet repayment after 3-5 years.

Although acting as incentives, the uncertainty of achieving a refinancing in both of options a) and b) means lenders will be required to record the legal maturity of the debt in assessing the severity of its internal capital usage, whilst option c) would leave the OFTO, Sponsors and OFGEM with the risk of lenders calling a default if the project cannot withstand the prevailing market costs associated with a refinancing. All of the above will impact the equity returns of the sponsor and ultimately increase the costs to consumer should there not be an appropriate mechanism in place that can facilitate a longer term financing solution for the project. The focus should therefore be on structuring the licence to provide access to a broader spectrum of funders during the distinct risk profiles of the OFTO, namely the construction and operational phases. Indeed it would seem most efficient to capitalise on the resources and due diligence skills that banks may provide during the construction phase which will in turn benefit new entrants (eg pension funds and insurers) when refinancing the project with a view to achieving best value for money for the consumer.

- One option to encourage new entrants to the funding market whilst providing the necessary certainty for shorter term lenders is through the provision of a refinancing cost pass through / sharing mechanism under the licence, subject to an agreed refinancing programme and trigger date agreed between lenders, sponsors and OFGEM. Where the barriers to refinancing are solely as a result of the prevailing market conditions (as opposed to any adverse performance of the project) we would anticipate a cost pass through under the licence that preserves the base case lending assumptions.

**Q3.18:** Do you have any comments on the issues associated with incorporating a refinancing gain share mechanism and how such a mechanism could be structured?

- The commentary in question 17 provides clarity on the refinancing mechanisms necessary for lenders to provide funding over the short term.
- What this doesn't address however, is the treatment of any refinancing ahead of the mandatory year 5 trigger date (which lenders would envisage as a backstop under the short term structure) and a benefit sharing mechanism should be considered in order to keep equity appropriately incentivised to pursue a long term take out of the bank debt during the early years of the licence.
- Such solutions have been adopted in other global infrastructure project finance markets however OFGEM should give careful consideration as to how it intends to balance the incentive for equity to achieve an early refinancing and what percentage of the gain share it would seek via a reduction in the TRS.

**Q3.28:** What are your views on whether the current approach to indexation, and in particular the proportion of the TRS subject to indexation, provides the best value to consumers? How might any alternative approaches be managed?

- Although not yet finalised, it is clear that the capital intensity for banks providing long-dated swaps is set to increase under Basle 3 proposals. This is particularly prevalent in the context of long-dated RPI swaps and in light of the high percentage of the overall revenue stream that debt service is attributed to, the burden of higher swap costs on the base case funding package will filter through to the equity returns and ultimately the consumer via an increased TRS.
- With this in mind we would encourage OFGEM to consider giving bidders the option to structure a bid with a partially indexed revenue stream, in accordance with long established principles used across the availability-based infrastructure PPP / PFI market. To be clear, under such a model, only the percentage of revenue stream relating to fixed costs, including debt service, would be fixed, with the remainder of the cost base being subject to indexation- and therefore naturally hedged. From OFGEM's perspective this should be viewed favourably as it provides greater certainty for the costs borne by the consumer without incurring the additional credit spreads / cost for long dated RPI swaps.

We expect that such a route is pursued only as an option for bidders to explore in developing a funding package, particularly in light of evidence to suggest that new potential lenders to the OFTO funding market, namely pension funds, may have an interest in a fully indexed revenue stream and debt package. Full revenue indexation could also be considered where the swap credit spreads are relatively low (e.g. where short-dated hedging is envisaged), or where market swap rates are favourable.

**Q3.29:** Do you agree that additional delivery incentives for OFTOs are not necessary?

- Although required under the STC, lenders will require clarity on the proposed inclusion of payment obligations / liquidated damages on the OFTO during the construction phase, particularly in relation to:
  - a) How OFGEM expects the OFTO to back off the obligations through the contractual framework;
  - b) What loss (if any) to either OFGEM or NGET is intended to be covered through the liquidated damages, particularly given that the revenue stream doesn't commence until final completion of the OFTO; and
  - c) The triggers for calling on the payment security under the incentive / penalty mechanism and the consequences of such payment security being called (lenders will typically wish to ensure that any provider of such payment security be subordinated to them).
  
- Subject to responses on the above, the inclusion of this mechanism will the impact the credit risk and any resultant financing and structural terms lenders consider for the OFTO. With the revenue stream not commencing until completion, the impact of these "incentives" are likely to be priced in by bidders, hence passed through to the TRS. We would therefore question whether such additional obligations such as LDs and security would provide value from a consumer perspective, given also the additional risk barriers that they will present to prospective and established lenders in the OFTO market. In our opinion, and based on our experience in the PFI/PPP and Infrastructure markets, the combination of (i) the payment stream not commencing until construction completion and (ii) delay LDs being typically due by construction contractors to indemnify the project company and allow it to meet debt service and other unavoidable costs are enough of an incentive to ensure the works are completed in a satisfactory and timely manner.
  
- Whilst we understand that the generator would wish to be paid LDs where OFTO is late delivering the transmission cables, OFTO will start to be paid post completion only and will therefore not be financially able to indemnify the generator for the delay.

**Q3.30** What are your views on what approach to decommissioning of assets would provide best ongoing value to consumers?

- In keeping with the obligations set out in TR1 and TR2 we would expect OFTOs to have received the necessary approvals from DECC and, to the extent necessary, the SoS in satisfying the obligations under the Crown Estate leases.
  
- It is important from a lender perspective that the decommissioning risk remains manageable and quantifiable throughout the term of the licence. With this in mind we expect that once sign off has been received prior to the licence commencement, any subsequent changes to the decommissioning obligations post Licence award, that result in increased costs will be supported by a commensurate increase in the revenue stream through the "Decommissioning Cost Adjustment Event" mechanism. Under the transitional regime, such an increase is only passed through under the licence where due to a change in legislative requirements. We believe it would be better value for money to remove such proviso as such proviso would, by its very nature, involve additional contingency being included within the financing structure/revenue stream to attempt to mitigate the additional decommissioning risk currently inferred.

- Given the back ended nature of decommissioning, lenders are most likely to have exited the OFTO by the time the obligations fall due. With this in mind, further confirmation from OFGEM as to whether alternative forms of decommissioning security (such as bonding and LC arrangements) could be procured by the OFTO immediately prior to the end of the initial TRS term may assist in making the TRS more cost efficient for the consumer on day-1. By agreeing the decommissioning strategy and budget in advance of licence commencement, OFGEM will retain certainty that sufficient cost allocation has been allowed for in the TRS, however by allowing this obligation to be secured against the residual value of the transmission assets, it would reduce the long term cost of financing it through the TRS. Lenders would however only be comfortable with the arrangement where the obligation to place decommissioning security kicks in post final maturity. This also assumes that decommissioning is not required should the licence terminate before the planned licence expiry date (typically year 20).
- As outlined above, we would view residual value and incentives to fall within the remit of equity rather than debt and would not expect to have it included within a base / banking case assumptions.

**Q4.3** Do you think there are further efficiencies we could make to the tender process and the transaction procedures for Generator build which would increase their efficiency and provide greater certainty to bidders and funders?

- Timing is critical to all parties and a timetable that remains as close to the original as possible is helpful as it provides greater certainty to both OFGEM and bidders / lenders.
- To put this into context it should be noted that the strength of pricing and credit support that bidders are required by OFGEM to procure from lenders is far greater at the ITT stage when compared to other infrastructure / PPP sectors. Putting aside the necessary due diligence and advanced internal approvals lenders need to go through to meet this level of support, the issue is compounded by:
  - the lengthy time horizon from ITT to financial close which makes it typically difficult for banks to hold their terms between ITT and financial close; and
  - the continued volatility and pricing uncertainty in the wider funding market.
- The result is that lenders need to appropriately caveat their support at ITT. With this in mind we would urge OFGEM to review the required level of lender support at ITT and in doing so could consider the following alternatives:
  - Mandatory and variant bids – akin to PPP / PFI at the ITT stage bidders may structure two TRS proposals, one to include specific funding terms and one based on generic funding assumptions provided by OFGEM. This would enable OFGEM to evaluate the merits and efficiencies within the competing bids for both the construction and operational phases, without the uncertainty of bank funding terms unnecessarily impacting the TRS at such an early stage in the bid process relative to financial close;
  - Degree of lender support – again referencing the PPP / PFI model, the letter of support at ITT would carry the support of each lender's senior management and acknowledge that pricing and credit approval would be sought following the announcement of preferred bidder.

- We would note that the key for maintaining an efficient process will be to capitalise on lessons learned from initial schemes as well as address current market issues. We have tried to flag these crucial areas for us as lenders throughout this submission and within the introductory note that we have provided.

**Q4.6** Do you have any suggestions on amendments which would improve the efficiency of the process for finalisation of transfer documentation and which would maximise value to consumers?

- The biggest efficiency around transfer documentation will most certainly come from lessons learned from the transitional tender exercises to date (as is noted within the consultation documentation).
- Generator buy-in to the process and a forward thinking approach by Generators will be very important, and the more that can be done around this the better. A greater incentive on the Generator to shape the underlying documentation into a form that is ultimately appropriate for transfer will be the main driver for greater efficiency. An appropriate underlying supply chain and an established methodology around construction techniques and methods will also assist, coupled with sensible approaches around underlying warranties and guarantees.
- With the visibility that OFGEM have to date over all schemes it would be beneficial for them to identify and target “key issues” from their experience to date i.e. areas where problems have been encountered and which could have or have resulted in significant delays. These could be shaped at a very early stage and an element of standardisation introduced.
- It will be helpful to receive confirmation from OFGEM that the rate volatility that is passed through under the TRS during the section 8A standstill period will also extend to any movements in the reference Gilt to the extent that a fixed rate funding package is pursued.

**Q4.7** What do you consider might be the implications of a share sale approach as opposed to a transfer of assets as has been seen to date?

- The legal implications of the share sale as opposed to a transfer of assets are not clear from the consultation documentation however the overriding principle from a lender’s perspective is that the adoption of a share sale should not result in a funding position any less secure than that achieved by transfer of assets, as per the transitional regime.

**Q4.8** Do you agree that the current split between costs priced into the TRS and those allowed as pass throughs provides best value for consumers?

- Decommissioning – As currently drafted the licence permits a pass through of additional decommissioning costs that arise as a result of changes to regulation during the course of the licence. As indicated in Q3.30, we believe that better value for money would be achieved where cost increases resulting from any changes to the decommissioning plan agreed with the relevant stakeholders (Decc / SoS / Crown Estate) are passed through under the TRS.

- Performance reserving / security – As currently drafted in the licence the obligation to procure performance security triggers 3 months prior to the 16th anniversary of the licence, even though in reality the reconciliation of any deductions is unlikely to occur until the end of the TRS. Whilst OFGEM has recently confirmed that the obligation can be met through reserving or “alternative security”, the latter clearly places a degree of uncertainty on the OFTO in the event that such security was no longer achievable. Whilst the implications of failing to meet the year 16 obligation are not currently clear, lenders would derive considerable comfort from either:
  - Confirmation by OFGEM that the OFTO can secure its performance obligations against the residual asset value at the end of the initial 20 year TRS (subject to agreed valuation metrics for the residual value); or
  - Confirmation that any course of action to recover performance deductions would not take place until the end of the initial 20 year TRS term.
  
- Insurance costs – Given the binary nature of the insurance market for transmission assets, a single major event is likely to impact the insurance costs across the entire sector. Although OFTO projects are well capitalised, the cash flow impact for such market-wide increases is not insignificant and given OFGEM’s objective of ensuring the OFTOs retain an investment grade rating, we suggest that subject to appropriate market-testing provisions, all insurance increases and deductibles incurred are passed through under the licence, thereby preserving the liquidity in the structure (that ratings agencies will look to).
  
- Oil & gas exploration – The OFTO is currently exposed to the risk of termination of the lease (leading therefore to termination of the licence) where the Secretary of State confirms that oil/gas works are to be carried out on the windfarm premises. Whilst the Secretary of state issued a ministerial statement on the subject in July 2011 to clarify the issue, we remain concerned that there is currently no legal obligation under the licence to pay compensation to OFTO. As a lender, we would also find it difficult to take the risk of such compensation being determined by an independent party without any prescribed legal formula as is currently proposed as such determination may be insufficient to compensate OFTO (and its lenders) in full.
  
- OFTO of Last Resort – where all other potential remedies for breach have been exhausted and OFGEM takes the decision to pursue licence revocation against the OFTO, the current drafting only permits the incoming OFTO an initial revenue stream period of 5-years. Whilst the OFGEM guidance clarifies that there is no limit to the number of successive periods, the constraint of the initial 5-year term is a significant factor in the senior lender risk assessment and debt recovery analysis. Further confirmation from OFGEM or amendment to the licence that preserves the ability of the OFTO to meet its senior debt obligations would suitably mitigate this risk.

**Q4.9** Are there any aspects of the current arrangements for transitional tender exercises or within the changes we have proposed above, which may prevent access to certain sources of finance under Generator build?

- The issues that we would note are very much the same issues as we have flagged to you within Question 3.17 and are focussed on the availability of long term finance. We would re-iterate these points under a Generator build option.

**Q4.10** Do you have any comments on the issues associated with incorporating a refinancing gain share mechanism for Generator build and how such a mechanism could be structured?

- Please see response to Question 3.18