

Offshore Transmission: Cost Assessment for the Ormonde transmission assets

Decision

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Overview:

This document sets out our cost assessment for the Ormonde transmission assets and the key principles that we have applied in our cost assessment process for the first transitional tender round. The Authority has used the assessment of costs to determine the value of the Ormonde transmission assets. The Authority has granted an offshore transmission licence to TC Omonde OFTO Limited, which is incorporated by Transmission Capital Partners (a consortium of Transmission Capital, International Public Partnerships and Amber Infrastructure Group).

TC Omonde OFTO Limited has incorporated the assessed transfer value as set out in this report into their tender revenue stream. The appendices published alongside this report are available on the Ofgem website. They include correspondence between Ofgem and the developer as part of the cost assessment process and external consultants' reports referred to in this document.

Context

Ofgem and the Department for Energy and Climate Change (DECC) have developed a regulatory regime for offshore electricity transmission. A key part of this regime is that offshore electricity transmission licences will be granted to Offshore Transmission Owners (OFTOs) following a competitive tender process run by Ofgem. The transitional tender regime has been designed for projects that were under development, in construction or constructed at the time of the announcement of the regime¹.

The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2010 (the Tender Regulations) provide the legal framework for the process which Ofgem will run for the grant of offshore electricity transmission licences. The Tender Regulations set out the requirement for the Authority to calculate, based on all relevant information available to it, the economic and efficient costs which ought to be, or ought to have been, incurred in connection with developing and constructing the offshore transmission assets in respect of a project in the transitional regime. The Tender Regulations provide for an estimate and an assessment of costs in relation to offshore transmission assets.

Where the Authority has determined to grant an offshore electricity transmission licence to the successful bidder in respect of a particular project, the assessment of costs shall be used by the Authority to determine the value of the transmission assets to be transferred to the successful bidder. This value will be reflected in the revenue stream in the offshore electricity transmission licence granted to the successful bidder.

At the time we commenced the cost assessment process, the transmission assets of the projects in the first transitional tender round, other than Barrow, were still under construction. For these projects we carried out an estimate of costs under the Tender Regulations before commencing the assessment of costs. This is the fifth cost assessment report for offshore transmission published by Ofgem.

Associated documents

- Ernst and Young report on Interest During Construction [Link](#)
- KEMA report on benchmarking [Link](#)
- The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2010 [Link](#)
- Offshore Transmission: Tender Rules [Link](#)
- Interest During Construction for Transitional Tender Rounds [Link](#)

¹<http://www.ofgem.gov.uk/Networks/offtrans/pdc/cdr/cons2009/Documents1/Main.pdf>

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Executive Summary

This document sets out the assessment of costs which ought to have been incurred in connection with the development and construction of the transmission assets for the Ormonde project and details the cost assessment process we have undertaken.

Key stages of the cost assessment process for Ormonde

The cost assessment process involved three key stages set out below.

- The initial calculation of costs for the Ormonde project was £87m. This was communicated to the developer in July 2009 and published in the preliminary information memorandum in July 2009 (the initial transfer value).
- The initial calculation was updated as a result of further information and continuing analysis. The updated calculation, which was £101.1m, was communicated to the developer in September 2009 (the indicative transfer value). The indicative transfer value was published in the project information memorandum.
- At this stage of the cost assessment process we have reached a final decision on the assessment of costs of £103.9m (the assessed transfer value).

The Ormonde project

Table 1 shows the movement between the initial, indicative and assessed transfer values, and the reasons for movements between the indicative and the assessed transfer value.

Table 1: Summary of cost breakdown history

| Category | Initial transfer value July 2009 (£m) | Indicative transfer value Sept 2009 (£m) | Assessed transfer value March 2012 (£m) | Reasons for change between Sept 2009 and March 2012 |
|-------------|---------------------------------------|--|---|---|
| CAPEX | 67.4 | 78.7 | 80.4 | £2.9m increase relates to late cable delivery, waiting on weather costs, vessel standby costs (£0.5m) reduction in cable supply costs Offset by (£0.7m) reduction due to disallowed Visser and Smit costs |
| Development | 10.2 | 12.6 | 13.9 | The developer submitted pre-acquisition costs at a late stage in the assessment process |
| IDC | 9.4 | 9.8 | 8.6 | The developer submitted a revised cash flow which reduced the period over which IDC was payable |
| Transaction | - | - | 1.0 | Transaction costs have been added as they are assessed at the end of the cost assessment process |
| Total | £87.0m | £101.1m | £103.9m | |

CAPEX

Table 1 shows that CAPEX is £1.7m higher overall from the indicative transfer value to the assessed transfer value. An increase of £2.9m was down to a number of factors including weather delays and vessel standby costs, which were all a result of the late delivery of the export cable. The CAPEX increase was offset by a reduction in the cable cost of £0.5m and disallowed costs of £0.7m. The costs we have disallowed are in relation to the cable installation process.

Development costs

Table 1 shows that over the duration of the project, development costs have changed due to reviews of the scope of the project management services assigned to the transmission assets. For the assessed transfer value, the development costs increased by £1.3m from the indicative transfer value due to a late submission for project pre-acquisition costs.

Interest during construction

The IDC allowance has decreased from the indicative transfer value to the assessed transfer value. This is primarily a result of the period of IDC entitlement ending in July 2011 as against the previous estimate of it running until January 2012.

Transaction costs

The transaction costs are composed of both internal and external resource costs of the tender process for the developer as well as tender fees that the developer has paid to Ofgem through the tender process. We have checked these costs to ensure that they have been correctly allocated by the developer.

Confirmations in relation to tax benefits

The developer has confirmed in a letter dated 14th March 2012, that the incoming OFTO will be able to obtain the full benefit of all available capital allowances. Therefore, no reduction to the assessment of costs has been made in relation to this issue.

Assessed transfer value for Ormonde

The assessed transfer value of the Ormonde transmission assets is £103,882,790.

1. Cost assessment process for TR1

Chapter Summary

The Tender Regulations set out the requirement for the Authority to calculate, based on all relevant information available to it, the economic and efficient costs which ought to be, or ought to have been, incurred in connection with developing and constructing the offshore transmission assets in respect of a project in the transitional regime. This chapter sets out the process that we followed in carrying out the TR1 cost assessment.

Overview of the TR1 cost assessment process

1.1. The Tender Regulations provide the legal framework for the process which Ofgem will run for the grant of offshore electricity transmission licences. This process includes assessing the economic and efficient costs of constructing and developing the offshore transmission assets to be transferred to the new OFTO.

1.2. The calculation of those costs shall be:

- where the construction of the transmission assets has not reached the stage when those transmission assets are available for use for the transmission of electricity, *an estimate* of the costs which ought to be incurred in connection with the development and construction of those transmission assets.
- where the construction of the transmission assets has reached the stage when those transmission assets are available for use for the transmission of electricity, *an assessment* of the costs which ought to have been incurred in connection with the development and construction of those transmission assets.

Data collection

1.3. To undertake this exercise we have gathered and reviewed a range of information and supporting evidence. Detailed cost information was provided by developers in the form of cost reporting templates, contract values, asset cost schedules and cash flows. These relate to the actual/forecast costs of construction contracts and development costs related to the transmission assets being transferred to the successful bidders.

1.4. The data collection to inform the cost assessment process commenced in December 2008 and has continued to date. Throughout this period we have worked closely with the developers of the relevant offshore transmission

assets. The information we have gathered relates to the following cost categories that are involved in the development and construction of the transmission assets:

- Capital expenditure
- Development costs
- Interest during construction
- Transaction costs

- 1.5. Developers have also provided supporting evidence to substantiate their cost submissions including, amongst other things, contract documentation, supplier payment lists and asset schedules. We have been supported throughout this process by Ernst and Young as financial and KEMA as technical advisers.

Process stages

- 1.6. The cost assessment process for the first transitional tender round involves the key stages set out below.

Initial transfer value

- 1.7. The initial transfer value calculated in July 2009 was based on cost submissions by the developer of each project. This value was made available to bidders at the Pre-Qualification (PQ) stage of the tender process. The letter we sent to developers at this time indicated that this calculation might be updated as a result of any further information provided by the developer and our continuing analysis.

Indicative transfer value

- 1.8. In September 2009, we provided the indicative transfer value for the commencement of the Qualification to Tender (QTT) stage of the tender process. This value was also used for the tender revenue stream bids submitted by bidders at the Invitation to Tender (ITT) stage. The letter we sent to developers in September 2009 indicated that this calculation might be updated as a result of any further information provided by the developer and our continuing analysis. For projects where the transmission assets were not yet available for the use of transmission (being all projects other than Barrow), this letter also provided a guarantee (subject to certain matters) that the minimum transfer value they would receive for the transmission assets once their project was completed would be 75% of the indicative transfer value.

Assessed transfer value

- 1.9. Once the transmission assets are complete or are close to completion and the developer has indicated that they have documentation to support an assessment, we will commence an exercise to determine the assessed transfer value.
- 1.10. A draft of the cost assessment report, including the amount of the assessed transfer value, will be sent to the developer and the preferred bidder for the relevant project. This enables either of these parties to comment on the factual nature of the report prior to the cost assessment being finalised by Ofgem.
- 1.11. The assessed transfer value will then be incorporated by the preferred bidder into their tender revenue stream for the purposes of the section 8A licence consultation and we do not expect any changes to the transfer value after this point. The draft cost assessment report will be published alongside the Section 8A licence consultation. The assessed transfer value will then be confirmed once the Authority has determined to grant an offshore transmission licence to the successful bidder. After licence grant the final cost assessment report will be published on the Ofgem website.

Updated indicative transfer value

- 1.12. Where it is not possible for us to complete the cost assessment prior to the asset transfer we will determine what proportion of the indicative transfer value the developer should receive on transfer of the transmission assets. This may be greater than or equal to the 75% minimum transfer value referred to in 1.8. We will also consider whether the indicative transfer value itself should be updated in light of further evidence arising from our cost assessment process since the indicative transfer value was published.
- 1.13. The indicative transfer value (updated where relevant) will then be incorporated into the tender revenue stream of the preferred bidder for the project along with the relevant cash flow reflecting the staged payment of the transfer value to the developer.
- 1.14. Once final costs are known and the developer can provide documented evidence, we will proceed to finalise our cost assessment. The deferred consideration (being the difference between the assessed transfer value and the proportion of the indicative transfer value received by the developer on transfer) will then be paid by the OFTO to the developer and the Post Tender Revenue Adjustment (PTRA) mechanism in the licence will be used to reflect the assessed transfer value.

Cost assessment analysis for TR1

1.15. We have applied two tests throughout the cost assessment process.

Test 1 - Assessing the accuracy and allocation of developers cost submissions

1.16. As a first test, we have checked the accuracy of developers' data and the appropriateness of cost allocations, in particular, between the offshore generation and transmission assets. Throughout the cost assessment process developers have provided cost information to us on an ongoing basis. Where we have identified discrepancies in how developers have allocated these costs we have checked with developers to assess if they have been allocated to the correct asset category and made adjustments accordingly.

1.17. To support the cost assessment process we have also undertaken a forensic accounting investigation. The scope of this investigation was shared with developers in advance. This investigation was based on the final costs that the developer has provided to us and was applied to a sample of contract costs. The actual sample for each project varied due to the different contracting strategies adopted by the developer and the specific needs of the project, but generally focussed on the most expensive contract and/or contracts which had material increases in costs.

1.18. The forensic accounting investigation was undertaken primarily to validate the cost allocations provided by developers. This may have indicated the need for amendments to the developer's submissions to reflect, for example:

- the actual costs incurred (eg in respect of exchange rates on foreign currency payments)
- more relevant metrics for the allocation of shared service costs.

1.19. Where amendments were in our opinion required and in the absence of further evidence from the developer to substantiate the original allocation, we incorporated the recommended changes from the forensic accounting investigation.

Test 2 - Assessing if developer's costs are economic and efficient

1.20. Under test two we sought to assess through appropriate analysis whether the costs had been economically and efficiently incurred by the developer. Where possible, we have sought to apply benchmarking and where industry wide cost indices were unavailable we have reviewed data from other projects within the first transitional tender rounds. This analysis has included benchmarking across the projects (see 1.21 below) and analysis in relation to funding interest rates

(see 2.14 - 2.20 below). We consider such approaches to be an important tool in assisting us in ensuring these costs are economic and efficient.

1.21. To help us calculate the indicative transfer value we undertook a benchmarking exercise using comparable costs across all projects in the first transitional tender round to identify any cost outliers across the main cost categories. Any cost outliers identified through the benchmarking exercise were then subject to further review. This exercise examined individual cost categories including:

- total cost of transmission assets as a percentage of overall project cost
- total cost of transmission assets per MW kilometre
- cost of offshore substation per secure MW
- cost of offshore substation (platform and electrical) per installed MW
- cost of submarine cable supply and installation per kilometre
- cost of transformer per MVA
- cost of reactive equipment per kilometre of cable
- development cost as a percentage of transmission assets.

1.22. This benchmarking exercise informed our communication to developers in our letter of September 2009 which set out the indicative transfer value.

1.23. We have also considered the procurement processes adopted by developers to obtain economic and efficient transmission asset costs. We have noted the differing procurement approaches taken by developers for the transmission assets in the first transitional tender round. We will keep the efficiency of developer procurement and contract management approaches under close review for future cost assessments.

1.24. Where CAPEX or development costs have increased since the indicative transfer value was set, developers have been asked to provide supporting documentation to justify why these increases occurred. Depending on the nature of the increase, we have undertaken a technical investigation which focussed on, for example, a particular cost increase in a distinct contract or multiple increases across several contracts.

2. Cost assessment principles

Chapter Summary

This chapter sets out the cost assessment principles we have adopted in determining the assessed transfer value for the first five projects within TR1 (Barrow, Robin Rigg, Walney 1, Gunfleet Sands and Ormonde). We intend to apply these principles in our cost assessment process for other projects in TR1. However, we may need to vary them or apply additional principles where appropriate in light of the analysis undertaken in respect of such projects.

Introduction

2.1. This chapter sets out the cost assessment principles we have adopted in relation to various cost categories for TR1 and the reasoning for such principles.

2.2. The principles set out in this chapter are:

- allocation of costs
- economically and efficiently incurred costs
- interest during construction
- treatment of contingency
- spares
- tax - VAT
- tax - capital allowances
- depreciation of operational projects
- transaction costs
- exchange rates
- outstanding costs
- capitalisation of operating costs

Allocation of costs

Capital expenditure

2.3. On all projects, there were some costs submitted by developers that have been split between generation and transmission. An example of this is where the cable installation contract covers both the export cables (transmission) and the inter array cables (generation) or if seabed surveys cover the entire wind farm. In such instances we have requested the allocation methodology and metrics that the developer has used to determine what proportion of the costs have been allocated as transmission costs. Such a methodology may be based on the relative proportion of direct equipment costs (ie excluding all shared costs)

for the transmission assets compared to the project as a whole. We have then cross-checked if the allocation of cost was based on the methodology and considered the metrics applied in order to ensure accuracy.

Development costs

- 2.4. Developers submitted a range of differing development costs, for example, the cost of undertaking design studies, seabed surveys, project management, costs related to gaining consents and the cost of acquiring the development rights from another party.
- 2.5. With support from our technical advisers we have analysed developers' initial cost submissions for development costs. At the time of this work our analysis showed that the range of development costs represented a high percentage of the total project costs (excluding financing). Our advisers have indicated that development costs typically represent between 10-15% of capital expenditure (for projects in the first transitional tender round). In calculating the assessed transfer value we have reviewed whether development costs are broadly in line with the range provided by our advisers. Where these differ markedly we have undertaken additional analysis to ensure that only appropriate development costs are allowed.
- 2.6. Given the wide range of different costs submitted across projects, it is important that these costs are allocated appropriately. We have required developers to identify these cost allocations. In some instances, costs have been identified that are more appropriately classified into other cost categories. Where this is the case developers were required to reallocate them.

Economically and efficiently incurred costs

Capital expenditure

- 2.7. Offshore transmission development and construction is a relatively new industry in which industry wide cost indices are not yet readily available. In order to assess whether the CAPEX totals proposed by developers were economically and efficiently incurred, we initially undertook a benchmarking exercise across all projects included in the first transitional tender round. This benchmarking exercise covered each of the main components of the transmission assets (ie cables, transformers, reactive equipment and onshore and offshore substations) and on an overall basis (eg cost per MW and/or as a percentage of the overall project including generation). Where any item of cost appeared to be an outlier above the norm, we carried out further investigations with the developer to assess if the costs were incurred on an economic and efficient basis.

- 2.8. Where expenditure on any main cost category or development costs had risen by a material sum since the indicative transfer value, further work was undertaken by our technical advisers to specifically review such cost items.
- 2.9. Together with the benchmarking data, we have noted the procurement and contract management approaches adopted by developers for the transmission assets. At this stage in the first transitional tender round we have decided not to apply a cap to any items of capital expenditure based on benchmarking as there has not been evidence to suggest that costs incurred are not economic and efficient. Instead we have focussed on the assessment of whether material cost increases are economic and efficient. However, we will keep this approach under review during TR1 and beyond as more data becomes available from completed projects.

Development costs

- 2.10. The development costs provided by developers may not be easily attributable to either the generation or transmission construction activities as they relate to the process of developing and constructing the offshore project (generation and transmission assets). We have therefore focussed our analysis on ensuring the allocation proposed by the developer is appropriate and that we have clarity on the reasons why costs may have changed during the cost assessment process.
- 2.11. At the indicative transfer value stage we compared the proportion of total costs represented by development costs on each project in order to identify specific areas for further review across all projects. At this stage in the first transitional tender round we have not applied a cap to development costs based on benchmarking as we have no evidence to suggest that these costs for projects in TR1 are not economic and efficient. However, we will keep this approach under review during TR1 and beyond as more data becomes available from completed projects.

Changes in ownership

- 2.12. Many of the projects in the first transitional tender round have undergone changes in ownership (ie the original developer has sold the rights arising from initial development) in the period from the initial award of the Crown Estate lease up to the completion of the transmission assets. The shareholdings in some projects have been amended during the period in which the cost assessment has been undertaken. The total acquisition cost paid by the purchaser may include aspects related to both generation and transmission. Only the costs which relate to the development and/or construction of the transmission assets (and their associated financing costs which are assumed to be included in the acquisition cost) may be included in the assessed transfer value. This may require the developer to use an appropriate allocation metric to split such costs between transmission and generation. In checking that overall development costs are within an appropriate range (as set out in 2.5) this also

provides a check that the costs incurred are appropriate, in light of project specific circumstances.

Interest during construction

2.13. IDC refers to the financing costs incurred by a developer in the period of developing and constructing the transmission assets. The total IDC for a project is driven by four key variables each of which needs to be economic and efficient. These are set out below and discussed in detail in the following sections:

- interest rate applied to the project
- duration of the financing
- cost items to which interest was applied
- the cash flow curve.

Interest rate

2.14. We have calculated IDC on a pre-tax nominal basis. The use of a pre-tax rate ensured that developers received a rate that enables them to meet the expected level of tax in the chargeable gain arising from the inclusion of financing costs in the assessed costs. This use of a pre-tax nominal basis is consistent with practice in onshore transmission price controls on reasonably incurred additional outlays not covered by the scope of the preceding price control.

2.15. For calculating the total IDC, developers were initially requested to provide cash flow information and the interest rates signed off on their project, supported by relevant internal (ie board level) documentation to verify the applicable rates. The first responses from developers were based on the rates sanctioned as part of their financial commitment to the project. These were used in calculating the indicative transfer value. We carried out further analysis on the interest rates for projects in the first transitional tender round and wrote to developers in April 2010 with the results.

2.16. This further analysis was required as the developers had provided a wide range of interest rates to be considered for the purposes of IDC and we were not convinced that the variation could be explained by underlying economic factors. Given the wide range of interest rates proposed, we considered what an appropriate cost of financing for such assets should be and whether there were reasonable grounds to impose a cap on the interest rate. In the absence of comparable benchmark data from other projects we decided to use appropriate wider industry data as explained below. We used our own internal assessment in conjunction with a report by our financial advisers to come to a conclusion on the appropriate cost of financing. The period considered by our financial advisers for their assessment of funding costs was 2005 to 2009.

- 2.17. As part of our assessment of appropriate interest rates, a number of factors were considered. Other than the first project completed (Barrow), the remaining projects in the first transitional tender round have largely been constructed and financed in the credit crunch period. The relative impact of the credit crunch reduced liquidity in the period examined. This meant that in general only the large integrated energy companies were able to develop and finance offshore wind farms at this time. Consequently these were the best comparators. These companies achieved gearing and beta levels indicated by our advisors. Other forms of funding were largely unavailable.
- 2.18. Our advisors concluded that the range of interest rates for the upper end of appropriate financing costs was 9.4%-10.8%. Given the impact of the credit crunch, the gearing and beta levels and the fact that other forms of financing were largely unavailable and for consistency across projects funded in the same period, we concluded that adopting the top end of the range would be appropriate. In April 2010 we wrote to the developers whose project interest rates were above 10.8% to inform them that, based on our analysis at that time, their rates were to be capped at 10.8%.
- 2.19. Where the developers provided evidence of a rate below the cap, their proposed level of interest rate has been used.
- 2.20. We noted in 2010 that the liquidity of funding for projects had improved. The level of debt available for prospective bidders for the transmission assets provides an illustration of this. Where project delivery programmes are delayed such that the majority of project funding falls outside the period examined by our advisers we may consider reviewing the appropriate interest rate cap for such TR1 projects.
- 2.21. We published a consultation and conclusion on IDC in August 2011 which sets our approach to IDC. We will review our approach to IDC (the rate, the cap and the date) from time to time and our approach to application may change in the future as market information on potential funding costs changes.

Duration of financing

- 2.22. Regulation 4 of the Tender Regulations provides that the Authority must calculate the economic and efficient costs of developing and constructing the transmission assets. For the purposes of IDC, we consider that development and construction ceases once the transmission assets are commissioned². The commercial supply of electricity to the transmission system which follows commissioning also indicates that the assets are complete and operational.

² In this context, we would view commissioning as hot commissioning which enables energisation of the transmission system.

- 2.23. Each transitional project developer will have a project specific commissioning programme for the assets that it is constructing. It is important to differentiate between commissioning activities that are associated with the transmission assets and the wind farm generation assets. Before generation assets can be fully commissioned, the commissioning of the transmission assets will need to have reached a stage that permits safe energisation of the transmission system and provides an offshore transmission system that is ready to transport electricity on a commercial basis. There may be occasions where transmission asset and generation asset commissioning activities occur in parallel.
- 2.24. With these distinctions in mind, we have determined that IDC should be allowed up to the point where the transmission assets have been constructed and are fit for use as a system, or as part of a system, for the use of transmission of electricity³. Where projects are phased, IDC will cease at the completion of each individual phase in accordance with the same principles. If we consider there is evidence of inefficient and uneconomic delays in the construction or commissioning programme for the transmission assets, the period of applicability may be curtailed to reflect this.
- 2.25. Where projects have been purchased from other developers, we consider that the IDC should commence on the date of the acquisition. IDC is not applied to the period over which the previous developer incurred costs because the purchase cost should reflect this.

Cost items to which interest was applied

- 2.26. IDC is only applicable to the cash flow that represents the capital expenditure and development costs. Where amendments have been made to the developers submitted cost information from either the allocation or efficiency test this has been reflected in the cash flow. This ensures that the IDC calculated for the transmission assets reflects the economic and efficient cost of developing and constructing the assets.

Cash flow curve

- 2.27. IDC is calculated on the actual cash flow which represents when payments were made against the contracts for developing and constructing the transmission assets. Some developers have sought to apply IDC to accounting data rather than their actual cash flows. This has not been used to calculate IDC as it does not represent the actual cost to the developer and includes non cash elements such as retentions, accruals for work completed and provisions. Where developers have provided accounting data or this has been identified

³ For the avoidance of doubt, this should not be confused with legal definition of transmission for transitional projects. The system becomes transmission only when transferred to an OFTO. However, we would not apply IDC to this point.

during the forensic accounting investigation we have sought the correction information from the developer.

Treatment of contingency

2.28. For projects still in the design or construction phase, developers' cost data forecasts for the initial and/or indicative transfer values have tended to include contingency amounts to deal with future uncertainty over the actual cost and timing of construction. The assessed transfer value does not include any contingency because construction has been completed and all costs should be either settled or agreed with suppliers or the developer should have provided a firm estimate (eg on tender costs). As a result, contingency has reduced to zero for the assessed transfer value.

Spares

2.29. Where spares for the transmission assets are to be transferred to the OFTO then we will allow them as part of the assessed transfer value, provided that they can be demonstrated to be economic and efficient.

Tax - VAT

2.30. HMRC have provided guidance in relation to whether the transfer of transmission assets can be viewed as a transfer of a business as a going concern (TOGC). HMRC have indicated that they would expect (subject to exceptional circumstances) that any transmission assets that are currently operational or fully constructed up to the point of operation at transfer would meet the TOGC conditions. Should any circumstances occur in which the transfer does not meet TOGC conditions and therefore is not free of VAT (eg as a result of further discussions between the developer, preferred bidder and HMRC), then the parties should seek arrangements with HMRC to minimise the working capital consequences of such a situation. This will have no impact on the assessment of costs or assessed transfer value.

Tax - capital allowances

2.31. Each transfer of assets from a developer to an OFTO under the transitional tender round is for a set of assets on an as-built basis, based on actual expenditure. We have therefore assumed for the cost assessment process that the purchaser will obtain the full benefit of all available capital allowances and that the transfer value should be reduced where such benefits do not fully pass across. This position was referenced in our letter to developers in September 2009. The indicative transfer value has been calculated on the basis that the purchaser obtains the full benefit of all available capital allowances. Where benefits do not fully pass across and any such tax benefit is retained by the developer (eg as a result of agreement reached between the developer and preferred bidder), which results in the purchaser not being able to obtain the

full benefit of all available capital allowances, we will reduce the assessment of costs. This reduction will be for an amount that reflects the value of the tax benefit retained by the developer.

Depreciation of operational projects

2.32. There are some projects in the first transitional tender round that have been operational for a period of time prior to the assets being transferred to the OFTO. We have considered depreciation in relation to such projects.

2.33. The design life indicated by manufacturers for offshore transmission assets is greater than 20 years. Therefore, at this stage in TR1 based on the assumption that the assets are capable of satisfying the 20 year life applicable to the revenue entitlement set out in the OFTO licence, and in the absence of evidence to suggest they will not do so, we therefore consider it reasonable not to apply depreciation to the assets. However we will keep this under review and consider depreciation on a case by case basis.

Transaction costs

2.34. Transaction costs relate to the costs that the developer has had to incur as a result of the tender process. These can be split into two categories:

- tender fees
- developer's external and internal costs

Tender fees

2.35. Tender fees relate to the fees charged to the developer by Ofgem as part of its cost recovery methodology. We are including these costs as transaction costs in the assessed transfer value. This is consistent with the costs incurred in the development and construction of a set of assets that are being prepared for sale immediately following completion of construction.

2.36. Regulation 5 of the Tender Regulations set out that where the Authority has undertaken an estimate of costs under the Tender Regulations, the developer has to make a payment in accordance with the Authority's cost recovery methodology⁴ in relation to the Authority's costs in this respect.

2.37. Regulation 7 of the Tender Regulations sets out that the developer is required to make a payment in relation to the Authority's tender costs as calculated in accordance with the Authority's cost recovery methodology for that tender exercise. For the first transitional tender round, developers have been required

⁴<http://www.ofgem.gov.uk/Networks/offtrans/rott/Documents1/Offshore%20Electricity%20Transmission%20Tender%20Rules.pdf>

to pay the Authority an administration fee of £50,000. This fee is considered to be a transaction cost and is recoverable by the developer.

- 2.38. Regulation 7 also sets out that developers are required to provide security in relation to the Authority's tender costs. For the first transitional tender round this was set on a sliding scale commencing at £500k per project. Developers were required to either provide this amount to Ofgem to be placed in an escrow account or in the form of a letter of credit (LOC). The costs of putting this LOC in place are included as transaction costs. Where security was provided into an escrow account, the developer will be entitled to the interest that the account has received. Where the security is returned to the developer any interest incurred along with the principle sum will be returned to the developer.

Developer's external and internal costs

- 2.39. To support their activities in the tender process developers may have had to utilise a range of resources or services including, for example, the production of legal documents or provision of financial advice to support the cost assessment. The use of external and internal resources by developers to support the tender process in this way is consistent with the costs incurred in the development and construction of a set of assets that are being prepared for sale immediately following completion of construction.
- 2.40. For the purposes of undertaking a cost assessment we have required developers to submit evidence to support the level of external and internal costs that they have submitted. These may be reviewed as part of the forensic accounting investigation.
- 2.41. For internal costs, developers are required to submit the names of personnel involved, the activities that they worked on, their day rates and the number of days spent on tender activities versus the number of days spent on the total project (non tender related activities) in order to substantiate any claims for such costs.
- 2.42. There may also be internal specialised staff charged directly to the project for undertaking work directly related to the tender process, eg this could include engineers, accountants, etc. Where this is the case we would similarly require the appropriate evidence of this.

Exchange rates

- 2.43. We recognise that developers will have adopted different approaches for paying contracts in foreign currency. For example, the developer may have hedged by fixing the forward exchange rate in advance. The payment of their contracts should then be based on such fixed rates. If the developer has not used this approach then the exchange rate must be based on the day rates applicable when payments were made out against the contract in line with the standard

accounting application of temporal rates. We have asked developers to outline their approach and provide supporting documentation as necessary. Where developers are unable or unwilling to provide the relevant calculations then we will determine the rate based on the forward rates applicable at the time that the contract approval was made.

Outstanding costs

2.44. When the cost assessment process is completed, cash payments made by the developer may not equal the assessed transfer value because there may be a number of outstanding non-cash items such as retentions, accrued invoices and provisions for work that is yet to be completed. If the level is significant (eg greater than 5% of the transmission assets), we have delayed our final assessment until a lower and more accurate figure is available. Where these non-cash items have been considered to be reasonable and do not amount to a significant percentage of the assessed transfer value they are treated as a firm commitment by the developer to allow the assessment to be completed.

Capitalisation of operating costs

2.45. We have decided not to allow the capitalisation of operating costs as this is not within the scope of the cost of developing and constructing the transmission assets. Examples of these costs include set up costs relating to ongoing operational costs (eg maintenance) that may have been capitalised.

3. Ormonde cost assessment

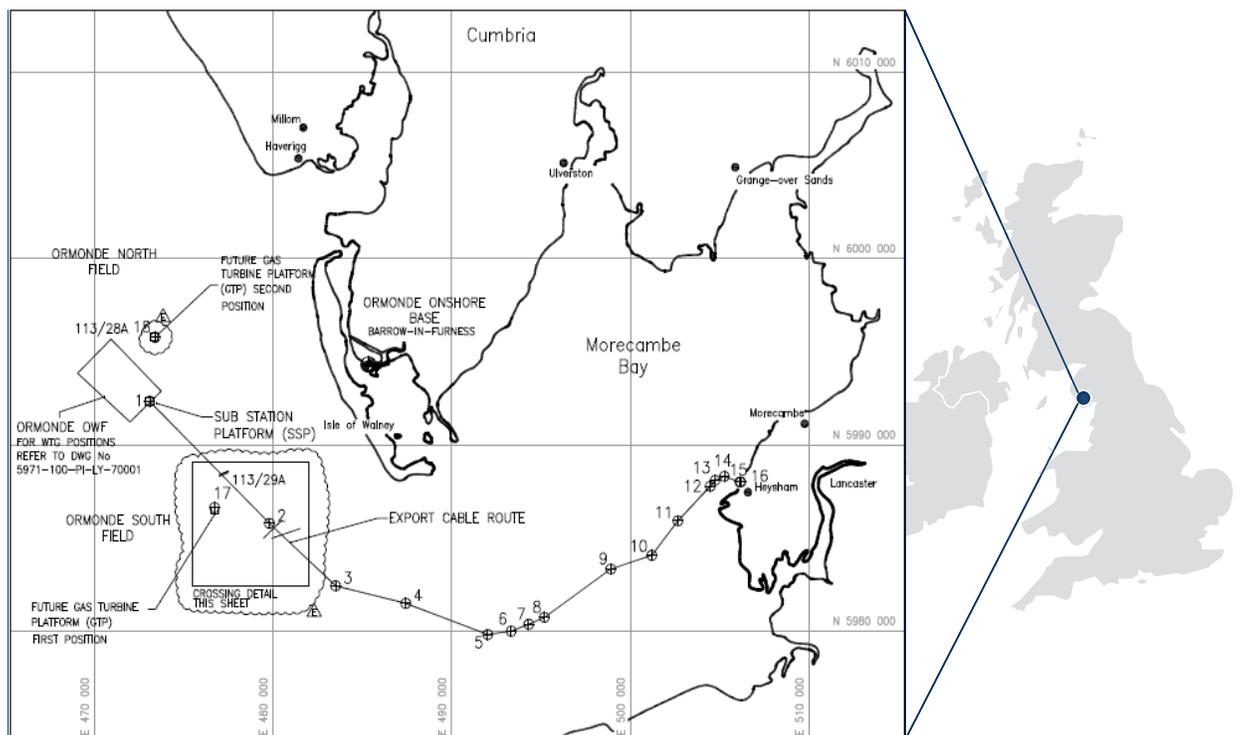
Chapter Summary

This chapter summarises how we have developed our cost assessment for the Ormonde transmission assets from the initial transfer value to the assessed transfer value, with an emphasis on the difference between the indicative and assessed transfer values. It provides a breakdown of the key cost categories that we have considered and highlights the decisions that we have made.

Ormonde transmission assets

- 3.1. The Ormonde Wind Farm is located approximately 10km from Walney Island, off the Cumbrian coast in northwest England. The Ormonde transmission assets were commissioned in July 2011. The Ormonde Wind Farm consists of 30 Repower 5MW wind turbine generators in total. The developer of the Ormonde transmission assets and the Ormonde Wind Farm is Ormonde Energy Ltd, which is owned 100% by Vattenfall Wind Power Ltd which in turn is owned 100% by Vattenfall Vindkraft AB.

Figure 1: Location of the Ormonde transmission assets



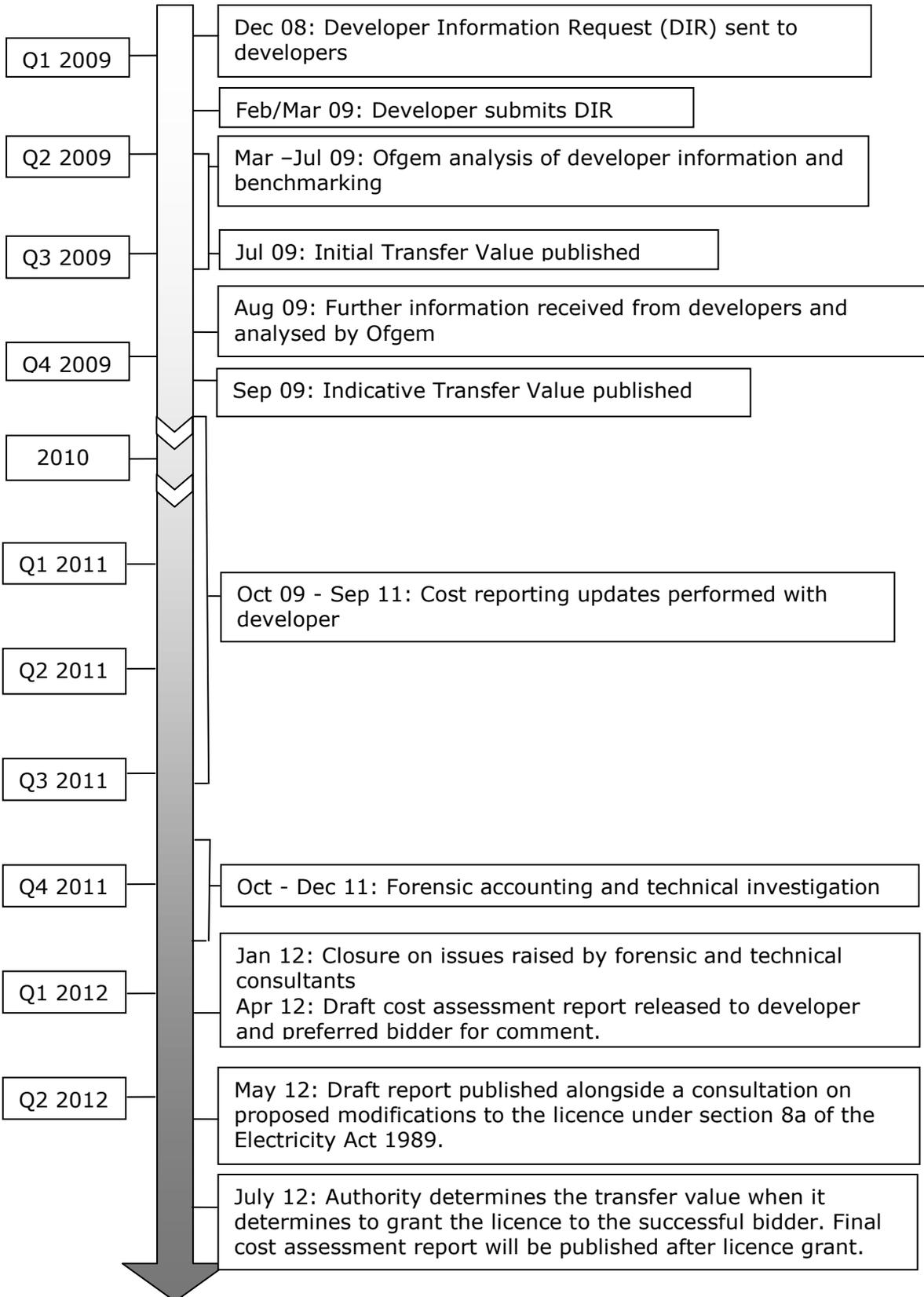
- 3.2. The assets that are transferring to the OFTO are the export cable, the offshore substation, the onshore substation and an onshore cable linking the subsea connection to the onshore substation. The boundary points are defined below:
- Offshore: Located at the incoming connections from the transformers on to the 33kV switchboards. In other words both the 33kV switchboards will remain entirely in the ownership of the developer.
 - Onshore: Located at the overhead disconnector of the Electricity North West (ENW) 132kV metering circuit breaker at the Trimpell 2 circuit of the Heysham substation.
- 3.3. Spares that are to transfer to the OFTO are subsea and onshore cables with associated joints, miscellaneous 132kV switchgear apparatus, relays, auxiliaries and SCADA spares.

Ormonde cost assessment process overview

- 3.4. Since December 2008, we have worked with the developer Ormonde Energy Limited (OEL) and our advisors to reach the assessed costs which will be used by the Authority to determine the transfer value of the transmission assets. The diagram below outlines the steps that have been taken in the cost assessment process for the Ormonde project.



Offshore Transmission: Cost Assessment for the Ormonde transmission assets



Process for determining the assessed transfer value

3.5. In Chapter 1 we set out the two tests that were applied to the costs submitted by the developer. These were to assess:

- the accuracy and allocation of the costs; and
- whether these costs were incurred economically and efficiently.

3.6. These two tests were applied to the developer's CAPEX, development, IDC and transaction costs submissions. In this chapter we identify the cost changes that have resulted from our assessment of the accuracy and allocation of the costs and how we have determined whether costs have been incurred economically and efficiently.

Accuracy and allocation

3.7. The Ormonde project was constructed on a multi contract basis. An ex-post forensic accounting investigation was undertaken to ensure that the costs reported to us by the developer were accurate in that they represented the actual costs incurred by the developer during the development and construction period. This investigation covered the four highest value contracts. We also checked that they were allocated to the correct asset category and had been allocated correctly between generation and transmission. To assess whether the costs have been allocated correctly we have taken into consideration the following:

- metrics used when allocating costs
- developer's submissions using our cost reporting template
- the findings of the forensic accounting investigation
- cash flow payments related to the transmission assets

Efficiency

3.8. After costs had been appropriately identified and allocated, we performed an assessment of whether these costs had been incurred economically and efficiently. We took into consideration the following:

- a benchmarking exercise undertaken in 2009 across all transitional projects to inform the indicative value and which was updated in early 2011 (appendix 5)
- a report on interest during construction (appendix 6)
- the findings of the forensic accounting investigation (appendix 7)

3.9. Ormonde is a transitional tender round 1 offshore project and is the 5th project to be assessed. As further projects are completed, it will be possible to make greater use of actual costs for benchmarking. This will be used in conjunction with the forensic investigation and technical assessments when determining the assessed transfer value.

Project specific issues

3.10. There have been two main issues for consideration when assessing the economic and efficient costs that have been or ought to have been incurred in delivering these transmission assets:

- The subsea export cable installation suffered delays as a result of the cable manufacturer, Prysmian, being late in delivering the cable. This had the consequential effect of significantly disrupting the cable-laying schedule, as the weather conditions during the deferred period were far worse than would have been expected under the original timeline. There were also logistical issues with respect to the prior contractual commitments of the cable-laying vessels. The cable-laying contractor, Visser & Smit, raised a number of variation orders (VOs) for the additional costs involved, which led to a negotiated settlement between the developer and Visser & Smit.
- There is some outstanding work in relation to harmonics equipment and rock dumping that will not be finished by the envisaged time of asset transfer.

3.11. These issues are discussed further in the section on assessment of CAPEX.

Cost summary

3.12. The initial transfer value in July 2009 was £87m. This was an estimated value, based on information received from the developer at an early stage in the construction and development of the project. A number of the developer's contracts were in the process of being finalised at the initial transfer stage and these were considered in greater detail when the indicative transfer value was set.

3.13. We established an indicative transfer value of £101.1m in September 2009. Following completion of construction and development of the transmission assets, the developer submitted further costs which would amount to a proposed transfer value of £109.4m⁵. Our assessment of the economic and efficient costs which have been or ought to have been incurred in connection with developing and constructing the transmission assets has established an assessed transfer value of £103.9m.

⁵ This includes an incorrectly calculated value for the IDC which was submitted in error by the developer

3.14. Table 2 below provides a breakdown of the changes in cost for the main components of the project at each of the valuation stages.

Table 2: Cost breakdown history

| Category | Initial transfer value July 2009 (£m) | Indicative transfer value Sept 2009 (£m) | Assessed transfer value March 2012 (£m) | Reasons for change between Sept 2009 and March 2012 |
|-------------|---------------------------------------|--|---|---|
| CAPEX | 67.4 | 78.7 | 80.4 | £2.9m increase relates to late cable delivery, waiting on weather costs, vessel standby costs (£0.5m) reduction in cable supply costs Offset by (£0.7m) reduction due to disallowed Visser and Smit costs |
| Development | 10.2 | 12.6 | 13.9 | The developer submitted pre-acquisition costs at a late stage in the assessment process |
| IDC | 9.4 | 9.8 | 8.6 | The developer submitted a revised cash flow which reduced the period over which IDC was payable |
| Transaction | - | - | 1.0 | Transaction costs have been added as they are assessed at the end of the cost assessment process |
| Total | £87.0m | £101.1m | £103.9m | |

3.15. The increase from an initial transfer value of £87m to an assessed transfer value of £103.9m is largely due to movements in CAPEX costs. The nature of this cost increase reflects the fact that the initial transfer value was produced at a very early stage of construction planning.

3.16. The total costs submitted by the developer for consideration in the cost assessment exercise were £109.4m. The issues we have considered in setting the assessed transfer value are detailed below.

Overview of CAPEX

3.17. Table 2 above gives an overview of the CAPEX cost movements between the initial, indicative and assessed transfer value. The CAPEX element of the assessed transfer value is £80.4m, which is £1.7m higher than the CAPEX element of the indicative transfer value. This £1.7m increase is the balance of: an initial increase of £2.9m (due to weather delays and vessel standby costs, both of which were largely a result of late cable delivery); a £0.5m reduction in the cable cost; and, disallowed costs of £0.7m in connection with the offshore cable supply and installation.

3.18. Table 3 below gives an overview of the CAPEX costs submitted by the developer for the purpose of the assessed transfer value and the CAPEX costs allowed in the assessed transfer value.

Table 3: CAPEX costs submitted/included in the assessed transfer value

| Category | Cost submitted by the developer for assessed transfer value | Costs included in the assessed transfer value | Difference between developer costs and the assessed transfer value |
|--------------------------------------|---|---|--|
| Offshore s/s | £30,692,647 | £30,692,647 | - |
| Offshore cable supply & installation | £32,038,933 | £31,317,240 | -£721,694 disallowed |
| Land cable | £4,348,356 | £4,348,356 | - |
| Onshore s/s | £13,627,039 | £13,627,039 | - |
| Connection costs | £436,776 | £436,776 | - |
| Total | £81,143,750 | £80,422,057 | |

3.19. Our advisors undertook an ex-post forensic investigation of the three highest value CAPEX contracts. These accounted for 94% of the total CAPEX costs submitted by the developer at the time the investigation was undertaken. In total this sample represents 73% of the assessed transfer value. The CAPEX contracts that we investigated were:

- Visser & Smit (installation of subsea cable)
- Prysmian (supply of subsea cable)
- Areva (installation of electrical package)

Accuracy and allocation of CAPEX costs

3.20. For the majority of CAPEX costs incurred on the project, it was relatively clear whether they should be allocated to the transmission or the generation assets in their entirety. Where costs have been split between generation and transmission, the developer has allocated the percentage to the transmission assets using cost drivers, which differ depending on the nature of the work undertaken. Only those costs related to the transmission assets were allowed for the initial, indicative and assessed transfer values.

3.21. CAPEX costs that were referenced to documentation that is clearly applicable to the transmission assets have been allocated by the developer to the transmission assets on an actual basis, for example, foundation and insurance costs.

- 3.22. The developer has allocated 3.2% of total foundation and borehole survey costs (£30,871) to the transmission assets. This allocation is based upon the number of foundations that relate to the transmission assets as a proportion of the total number of foundations. We agree that this is an appropriate allocation method.
- 3.23. The developer has allocated 18% of total insurance costs (£967,419) to the transmission assets. The allocation is based on the total cost of the transmission assets as a proportion of the total cost of the Ormonde Wind Farm Assets. We consider that this is an appropriate means for allocating the insurance costs.
- 3.24. The project experienced construction delays in the laying of both the export and inter-array cables. These delays resulted from the late delivery of the export cable by Prysmian, the cable manufacturer and supplier. As a result, the developer made a claim under the Prysmian contract for liquidated damages. This amount has been deducted from the CAPEX cost for the Prysmian contract for the purpose of the assessed transfer value.
- 3.25. The cable delivery delay resulted in increased cable installation costs⁶, in respect of which the cable installation contractor, Visser & Smit, raised a number of variation orders (VO). Of the VOs raised by Visser & Smit, the developer agreed a negotiated final contract settlement. We have reviewed the rationale for this allocation and consider the costs have been appropriately allocated.

Efficiency of CAPEX costs

- 3.26. We have reviewed the additional CAPEX costs submitted by the developer, and considered the advice of our technical advisors. We have decided to disallow £0.7m of this proposed increase in relation to the export cable supply and installation, on the basis that it was not economically and efficiently incurred (as detailed further below).

Export cable supply and installation

- 3.27. The project experienced construction delays arising from the late delivery of the export cable. We undertook a technical investigation to understand the problems that were encountered and whether the additional costs proposed by the developer were economic and efficient. The following sections expand on the nature of the Visser & Smit variation orders; the findings of our technical investigation; and, our view on the efficiency of the costs incurred.

⁶ Increased costs were as a result of vessel waiting on weather, vessel standby and additional cable burial charges

Visser & Smit claims

- 3.28. The settlement between the developer and Visser & Smit was made up of VOs that the developer considered to be valid (and therefore accepted in full) and VOs that the developer considered were partially valid. The developer rejected a number of the Visser & Smit VOs as not valid. It also included a number of adverse weather claims raised by Visser & Smit, and which were allocated to the transmission assets by the developer.
- 3.29. The claims accepted by the developer as valid in the settlement related to the burial of the export cable and adverse weather relating to the export cable spread.
- 3.30. Visser & Smit raised waiting on weather claims as a result of delays experienced when laying the export cable. We understand that Visser & Smit applied limiting weather criteria for laying and simultaneously burying the export cable, which they were permitted to do under the contract. A small section was surface laid due to adverse weather conditions. Visser and Smit were then instructed by the developer to return later to bury the cable, which resulted in Visser and Smit raising a further VO for the cost of the additional trenching. The developer has categorised this as a partially valid claim and has accepted the claim for 5km of cable burial.
- 3.31. Visser and Smit raised a VO for additional management costs, vessel stand by costs and weather delays related to the vessel transit, all of which they claimed were incurred as a result of delay to the export cable delivery. The developer has categorised this VO as a partially valid claim and has accepted a proportion of the VO claim (which relates to vessel waiting costs).

Conclusions of the KEMA technical investigation

- 3.32. KEMA reviewed the basis for the validity of the developer's acceptance of the Visser & Smit claims, and concluded that some of the claims considered as partially valid could have been more strongly disputed. It acknowledged that the developer was probably correct in settling on the claims it considered as valid.

Ofgem's view on efficiency of cost incurred

- 3.33. In considering whether the Visser and Smit costs increases were economically and efficiently incurred, we note that the developer has sought to minimise costs incurred as a result of the late delivery of the cable by Prysmian. It reached a contract settlement with Visser & Smit which resulted in a substantial reduction in the associated claims for its assessed transfer value submission. We have also taken account of the fact that the developer obtained a liquidated damages claim against Prysmian for late delivery of the cable, and that has been offset against the CAPEX costs submitted by the developer.

- 3.34. We also note that our technical consultant considered that the developer could have more strongly disputed some of the Visser & Smit claims which the developer assessed as partially valid. However, a significant area of concern for us is that the developer does not seem to have acted in a manner such that costs would have been avoided in the first place. We recognise that the developer was unable to source the cable from another supplier once it became clear that Prysmian was not going to deliver on time. We have not received any indication of any pre-emptive action being taken once it had been made aware of the delay in the supply of the cable. We consider that pro-active management of the contracts at that stage could have averted a portion of the subsequently incurred costs. Further, it is not clear whether the actions subsequently instructed by the developer were optimal in relation to minimising the costs incurred for the transmission element of the overall project.
- 3.35. In accordance with our statutory duty to determine the economic and efficient costs that ought to have been incurred in the construction of these assets, we have decided that 50% of the Visser and Smit contract settlement for the partially valid claims (£0.7m) should not be included in the assessed transfer value. We consider this is a proportionate disallowance to reflect the level of costs that could have been avoided by a more pro-active response to events as they unfolded. In accordance with our statutory duty to determine the economic and efficient costs that ought to have been incurred in the construction of these assets, we have decided that 50% of the Visser and Smit contract settlement for the partially valid claims (£0.7m) should not be included in the assessed transfer value. We consider this is a proportionate disallowance to reflect the level of costs that could have been avoided by a more pro-active response to events as they unfolded.

Harmonics design costs

- 3.36. The KEMA technical review also considered the harmonics costs. Harmonic filters are to be installed on the offshore transmission assets. This will be concluded after asset transfer and the developer has provided a firm estimate of design and construction costs. The value is fixed and any cost over/under runs will be absorbed by the developer. The technical investigation noted that the Areva contract for installation of the electrical package included a provisional sum for design, civil works, installation, testing and commissioning of harmonic filters. Two VOs were raised by Areva; one related to the harmonic filter design costed on a time and materials basis; the other for the procurement, supervision, supply, installation and testing of the harmonics filtering equipment.
- 3.37. The design for harmonic filters was based on a nominal 20MVar, 132kV connected filter. A VO was placed in September 2011 for the required resources to carry out a detailed design of the project's harmonics filters. The VO was estimated at the previously quoted costs and the final design value was to be assessed on a time and materials basis. The description of the VO suggests that the scope covered design resources only. A more detailed breakdown of the VO amount showed that it comprised of design and other costs such as project management and civil engineering costs.

3.38. Considering that these other elements are included in the design cost, the technical review concluded that this level of cost is reasonable and comparable to other similar offshore projects.

Development costs

3.39. The total development cost calculated for the Ormonde transmission assets in the assessed transfer value is £13.9m. These are costs incurred by the developer which were outside the scope of the main construction contracts. For the purposes of informing our cost assessment our advisors undertook a forensic investigation of the ODE (Project management and offshore substation design) contract.

Accuracy and allocation of development costs

3.40. The development costs for Ormonde cover a variety of items relating to consultancy, engineering, legal costs, etc. The majority of items were common to both transmission and generation and have been allocated accordingly by the developer. The split the developer has applied is 18% to transmission. We have analysed these allocations individually and as an overall aggregate to ensure that they are appropriate.

3.41. Project management has been undertaken by ODE and the costs and activities have been reviewed by our advisors. The allocation to the transmission assets has been based on timesheet data and expenses records that were maintained by ODE. The project management cost includes an element of the developer's own staff costs. The developer's timesheets have been recorded in an SAP system after being approved by relevant management. The staff costs were calculated on the basis of hours recorded multiplied by a predetermined rate. The rate covered a number of costs including wages, pensions, holidays, office rental and other indirect costs.

3.42. The developer made a late submission relating to project pre-acquisition costs. These costs had not been requested for the indicative transfer value. We have reviewed the evidence supplied to justify these costs and are satisfied that they have been appropriately allocated to transmission.

Efficiency of development costs

3.43. The total development costs, excluding pre-acquisition costs, represent 15% of total CAPEX and 12% of the CAPEX and development costs of the transmission assets. This is within the 10% to 15% range that our advisors believe to be appropriate for transmission projects. The pre-acquisition costs were incurred in order to gain the project. The allocation is considered reasonable, is consistent with our published principles (see 2.12), and has been allowed elsewhere eg Barrow.

Interest during construction (IDC)

3.44. The total IDC calculated for the Ormonde transmission assets in the assessed transfer value is £8.6m based on the developer’s calculation of the interest rate to completion of the assets over a period from December 2008 to July 2011. The main changes from the indicative transfer value are a result of the developer submitting an actual cash flow, replacing accounting data originally submitted, and reductions in the period of the cash flow. See table 4 below for the IDC costs submitted by the developer and the value of IDC included in the assessed transfer value.

Table 4: IDC costs submitted/included in the assessed transfer value

| Category | Cost submitted by the developer for the assessed transfer value | Costs included in the assessed transfer value | Difference between developer costs and the assessed transfer value |
|----------|---|---|--|
| IDC | £12,864,760 | £8,576,196.7 | -£4,288,563 |

Accuracy and allocation of IDC

3.45. The cash flow that the developer provided for the indicative transfer value represented accounting data and not a cash flow with actual payment dates of costs under the contracts. The period of application of IDC was forecast to end in January 2012. For the assessed transfer value the developer provided an actual cash flow with the IDC ceasing in January 2012. Previously the developer had written to us stating that the actual date of completion of the transmission assets was July 2011.

3.46. For the purposes of IDC, we consider that construction ceases once the transmission assets are commissioned⁷. The commercial supply of electricity to the transmission system which follows commissioning also indicates that the assets are complete and operational. Entitlement to IDC ceases when the assets are ready to transmit and so we have stopped the project’s IDC from July 2011.

3.47. The CAPEX costs that we have disallowed have been removed from the cash flow at a period which is relevant to when the work was invoiced or undertaken.

⁷ In this context, we would view commissioning as hot commissioning which enables energisation of the transmission system.

Efficiency of IDC

- 3.48. The original IDC rate submitted by the developer was below the proposed cap level to be applied during construction.
- 3.49. As stated in 2.23, Ofgem determined that IDC should be allowed up to the point where the transmission assets have been constructed and are fit for use as a system, or as part of a system, for the transmission of electricity. Due to problems with the delivery of the export cable (detailed above), the installation of the Ormonde export cable was delayed from 9/6/2010 to 11/11/2010; the construction period was also longer than predicted.
- 3.50. The new cash flow and a reduction in the period of financing (which has been limited to the construction period of the transmission assets rather than the entire wind farm) has resulted in a reduction of £1.3m from the indicative transfer value IDC figure of £9.8m and a reduction of £4.3m from the developer's submission for the assessed transfer value.

Transaction costs

- 3.51. The indicative transfer value did not contain any transaction costs as they were not known at the time. The developer has submitted their view of the transaction costs incurred to date and a firm estimate of the costs they expect to incur to asset transfer. The total of these items results in the transaction costs element of the assessed value being £1m.

Accuracy and allocation of transaction costs

- 3.52. The developer provided information regarding both internal and external costs. For their internal costs they provided information on the personnel who were involved and their day rate relating to the work undertaken and time spent on the tender process as opposed to the construction of the project or generation activities. The external costs related to professional services in respect of the tender, eg legal, accountancy and technical. We have concluded that the costs provided by the developer were allocated appropriately.

Efficiency of transaction costs

Transaction costs can only be provided to us by developers to a reasonable degree of accuracy towards the end of the tender process. The transaction costs submitted by the developer represent less than 1% of the total CAPEX and development costs. Table 5 below sets out a comparison of transaction costs for Ormonde compared to other projects:

Table 5: Transaction costs submitted/included in the assessed transfer value

| Project | Assessed transfer value £m | Transaction costs £m | Transaction costs as % of transfer value |
|----------------|-------------------------------|-------------------------|---|
| Robin Rigg | 65.5 | 0.7 | 1.1% |
| Gunfleet Sands | 49.5 | 1.3 | 2.6% |
| Barrow | 33.6 | 1.4 | 4.2% |
| Walney 1 | 105.4 | 1.7 | 1.6% |
| Ormonde | 103.9 | 1.0 | 1.0% |
| | | | |
| Average | | | 2.0% |

3.53. As the Ormonde project is the 5th project to be assessed in the first transitional tender round there are a limited number of developers with transaction costs to which we can benchmark transaction costs. Furthermore, the costs that we do have are not directly comparable to other projects due to developers adopting differing approaches to meet the demands of the tender process and the fact that some developers have split their resource across multiple projects in the tender round. We have therefore not applied benchmarking but we have considered the reasonableness of the types of resource costs incurred in relation to the tender process.

3.54. As more tenders are completed we will have access to a greater pool of transaction costs that developers have incurred and it will be possible to make greater use of actual costs for benchmarking. We have otherwise relied on ensuring costs are accurate in order to ensure the associated transfer value is appropriate for the Ormonde transmission assets.

Hedging

The developer has used a Euro to Sterling exchange rate of Euro1.1562/£ as the hedging rate to be included in the assessed transfer value. This is based on the main euro based contract with Prysmian which was signed the first week in July 2009. This rate is supported by spot rates of this level during that week. We treat the hedging gain or loss as an economic and efficient cost on the basis that it is prudent practice for companies to hedge foreign currency risk in this way given their income is in sterling. This is consistent with the approach taken on other TR1 projects.

Contingency

3.55. The indicative transfer value did not contain a separate contingency value. The developer has since provided estimates for future payments in relation to the transmission assets for inclusion in the assessed transfer value.

Provisions for work in progress

3.56. The costs submitted by the developer included accrued amounts in respect of rock dumping and design and installation of harmonics which, although agreed to contract or VOs, have not been invoiced as at 31 December 2011 and are not yet therefore reflected in purchase invoices, accounting ledgers or the Developers bank statements. ODE has stated that purchase invoices will be issued and final payments made in respect of accrued amounts by September 2012.

Confirmations in relation to tax benefits

3.57. As stated in 2.31 the indicative transfer value was calculated on the basis that the purchaser would obtain the full benefit of all available capital allowances. If this was not the case for the assessed transfer value we would reduce the assessment of costs for an amount that reflects the value of the tax benefit retained by the developer. For the assessed transfer value the developer has confirmed that the purchaser will be able to obtain the full benefit of all available capital allowances and therefore it has not been necessary to reduce the assessment of costs.

4. Conclusion

- 4.1. In conclusion, in accordance with Regulation 4 of the Tender Regulations, the Authority has assessed the economic and efficient costs which ought to have been incurred in connection with developing and constructing the Ormonde transmission assets to be £103,882,790.

Appendices

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Appendix 1 – The Authorities powers and duties

Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below). The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.⁸ Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This appendix must be read accordingly.⁹

The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with;

- the shipping, transportation or supply of gas conveyed through pipes
- the generation, transmission, distribution or supply of electricity
- the provision or use of electricity interconnectors

Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote competition) in which the Authority could carry out those functions which would better protect those interests.

⁸ Entitled “Gas Supply” and “Electricity Supply” respectively.

⁹ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

In performing these duties, the Authority must have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met
- the need to secure that all reasonable demands for electricity are met
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them¹⁰
- the need to contribute to the achievement of sustainable development.

In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.¹¹

Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed¹² under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity
- secure a diverse and viable long-term energy supply
- and shall, in carrying out those functions, have regard to the effect on the environment.

In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated

¹⁰ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.

¹¹ The Authority may have regard to other descriptions of consumers.

¹² Or persons authorised by exemptions to carry on any activity.

National Competition Authority under the EC Modernisation Regulation¹³ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

¹³ Council Regulation (EC) 1/2003.

Appendix 2 - Glossary

A

Authority

The Gas and Electricity Markets Authority

C

CAPEX

Capital Expenditure

CBA

Cable Burial Agreement

D

DECC

Department of Energy and Climate Change

I

IDC

Interest During Construction

IM

Information Memorandum detailing the projects details released to QTT bidders through the tender portal October 2009.

ITT

Invitation to Tender

M

MW

MegaWatt

MVA

MegaVoltAmpere



O

[OFTO](#)

Offshore Transmission Owner

P

[PIM](#)

Preliminary Information Memorandum on the project released at the TR1 PQ stage in July 2009.

[PTRA](#)

Post Tender Revenue Adjustment

Q

[QTT](#)

Qualification to Tender

S

[SCADA](#)

System Control and Data Acquisition

[TR1](#)

Transitional Tender Round 1