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Date: 8 July 2009

Dear Tony,

Walney II – Confirmation of Transitional Project Status and Next Steps

Introduction

As you will be aware, the regulatory regime for offshore electricity transmission reached a major milestone, Go Active, on 24 June following the commencement by the Secretary of State of sections 90 and 91 of the Energy Act 2004. This followed on from the making of the Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2009¹ (the Tender Regulations), which came into force on 2 June.

In anticipation of Go Active, we wrote to you at the beginning of June to provide you with an update on recent developments in respect of:

- the offshore electricity transmission regime as a whole,
- the changes which have been implemented relating to the standard conditions of the electricity transmission licence and the relevant industry codes, and
- arrangements in relation to the first round of transitional tenders.

Commencing the Tender Process

Now that the required legal framework for the offshore electricity regime is in place, we will shortly be commencing the first round of tenders in the transitional regime. From our engagement and written correspondence exchanged with you over recent months, we understand that, in effect, you require us to start a tender exercise to identify a person to whom we would grant an Offshore Electricity Transmission Owner (OFTO) licence. If this is not correct or no longer remains the case, please notify us by return.

Scope of this Letter

This letter sets out:

- a further update in relation to our cost assessment process,
- confirmation of your qualifying project status,
- details of the payment and security in relation to the Authority's costs that you are required to provide to participate in the process,
- the entry conditions that you will need to meet in order to enter into the first round of tenders in the transitional regime, and

¹ http://www.opsi.gov.uk/si/si2009/uksi_20091340_en_1

- the timetable for meeting the requirements set out in this letter and the associated annexes.

Cost Assessment

Ofgem, with input from its external advisers, has reviewed the information that you have provided in respect of Walney II to enable us to calculate the economic and efficient costs in connection with developing and constructing your project. We have considered your submitted estimate of your costs of £104.4 million in relation to Walney II and all relevant information available to us with respect to the main capital items (such as electrical lines, cables and transformers) of the transmission system and other costs (such as the costs of obtaining consents, overheads and financing costs).

However, there are specific aspects of the information that you have recently provided (such as system compliance status, system boundary, contracted position, and other costs including tax), that we are continuing to analyse. This may lead to further engagement with you over the coming weeks in the period up to QTT. As a result of any further information that we might obtain from you and our continuing analysis, we may update our calculation of the economic and efficient costs associated with developing and constructing your project.

For the tender to commence this month we calculate the costs associated with developing and constructing your project at £104.4 million, which assumes an ownership boundary at the transformer cable sealing end of the 33kV cables connected to the 132/33kV transformer that you confirmed in your response to our June letter. This also assumes export rights of 182.7 MW at the offshore connection point², that the project is completed by July 2011³ and is compliant with all relevant requirements set out in the industry codes and technical standards⁴. You should be aware that we are requesting you to set out detailed project information as part of the response to the Information Memorandum, including in respect of the expected minimum availability for the transmission assets. We will be discussing this with you further in due course.

This calculation is not an endorsement by the Authority of the basis on which you derived your estimated costs or any assumptions or methodology that you used in your calculation and should be only be viewed as acceptance by us that based on all the relevant information available to us, your estimated transfer value of £104.4 million falls within a range of reasonable outcomes. Consequently, we have decided that this estimated transfer value does not warrant adjustment at this time for the purposes of commencing the tender process.

Before the commencement of the Qualification to Tender (QTT) stage of the tender process, we expect to provide developers with a letter of comfort, which for the purposes of setting out 75 per cent of the economic and efficient costs incurred or to be incurred, will reflect any adjustment to the estimate. The letter will provide confirmation that once a developer's project is completed they will receive a guaranteed minimum of 75 per cent of our estimate or 100 per cent of our assessment of the economic and efficient costs associated with developing and constructing their project, whichever sum is greater. For projects that are constructed, developers will receive 100 per cent of our assessment of the economic and efficient costs associated with developing and constructing their project.

² This is based on the information provided by you in response to the PIM information request (section 7). It is anticipated that this would be reflected in the agreements entered into by the developer and NGET in accordance with the CUSC, in due course.

³ This is based on information provided by you in response to the PIM information request (section 8) in respect of the offshore transmission system.

⁴ The assumption applies unless you advised of any compliance issues in response to the PIM information request. Where any compliance issue has been identified, we would expect that appropriate mitigation measures have been identified to address the outstanding issue, and information about those mitigation measures and the arrangements for their implementation is provided as part of the tender process.

While a calculation of your costs is a critical input into the tender process, we note that the actual asset transfer value for Walney II will be determined by the terms of the executory Sale and Purchase Agreement (SPA) with the successful bidder and our assessment of the economic and efficient costs associated with the completed assets. These are not yet fully known.

Many projects are under development and it will be some time before outturn costs are confirmed. Moreover, the allocation of costs between your windfarm and transmission system, which will influence the actual transfer value for Walney II, will only be determined once the terms of transfer have been agreed with the successful bidder. The transfer terms may also influence the level of other costs in our assessment (for example financing costs, tax liabilities and asset depreciation).

Once the transmission assets of your project are completed and available for use for the transmission of electricity, and the terms of transfer have been agreed with the successful bidder, we will undertake an assessment of the economic and efficient costs associated with developing and constructing your project. This will need to further consider the treatment of other costs (such as interest during construction, asset depreciation, tax liabilities and development costs) and take account of the agreed terms of the SPA.

Qualifying Project Status

As you are aware, for a project to qualify as a transitional project, the developer must demonstrate to Ofgem's satisfaction that the project meets the qualifying project pre-conditions⁵ set out in the Tender Regulations. Should these transitional qualifying project pre-conditions be met, the developer then needs to demonstrate compliance with the entry conditions in order to participate in the first transitional tender round.

Following Ofgem's detailed review of the information that you have provided in respect of Walney II's compliance with the transitional qualifying project pre-conditions, we consider that not all of these criteria have been met. We confirm that you have demonstrated the requirements in respect of your connection agreement⁶ and that you have secured necessary financing for the project⁷. However, there are some issues still outstanding. These are set out in Annex 1. As you will be aware, the Tender Regulations provide us with some discretion in respect of (i) the consents and property rights requirement⁸ and (ii) the contracts requirement⁹. You have advised us that these outstanding issues will be addressed shortly.

Notwithstanding these issues, we acknowledge that, according to the project plan for Walney II and other evidence that your company has provided, there is a significant probability that the qualifying project pre-conditions will be substantially met prior to the dates that Ofgem has set out in this letter for meeting the tender entry pre-conditions. As a result, we deem Walney II as a transitional project, on the basis that we are satisfied that your company will use its reasonable endeavours to resolve the outstanding issues identified in Annex 1 within the timeframes that you have indicated to us (and as also set out in Annex 1). This assumes an ownership boundary of the transformer cable sealing end of the 33kV cables connected to the 132/33kV transformer, export rights of 182.7 MW at the offshore connection point, that the project is completed by July 2011 and is compliant with all relevant requirements set out in the industry codes and technical standards.

We will maintain dialogue with you on progress of these matters so we are able to assess your position in respect of satisfying the tender qualifying project pre-conditions. A material failure to progress these matters may mean that Walney II is no longer deemed a

⁵ As defined in paragraph 2 of Schedule 1 to the Tender Regulations.

⁶ Paragraph 2(a) of Schedule 1 to the Tender Regulations.

⁷ Paragraph 2(d) of Schedule 1 to the Tender Regulations.

⁸ Paragraph 2(b) of Schedule 1 to the Tender Regulations.

⁹ Paragraph 2(c) of Schedule 1 to the Tender Regulations.

qualifying project and this may be treated as an event of disqualification under the Tender Regulations¹⁰.

Payments and Security

Further to our email dated 3 July, we confirm that we require payment and security from developers in relation to our tender costs for qualifying projects to participate in the tender exercise. This is in accordance with Regulation 6 of the Tender Regulations. Given that your project is considered a qualifying project, you are now required to:

- a) Provide security of £500,000 as either:
 - i) An unconditional Letter of Credit drawn on a Bank, with an investment grade credit rating¹¹ of "A" or better, from a country that also has a credit rating of "A" or better in the exact format set out in Annex 2; or
 - ii) A deposit of cash into our bank account (details are provided in Annex 3).
- b) Pay the administration payment of £50,000 (details are provided in Annex 3).

As set out above, we expect to advise you of our final ex ante cost estimate prior to the QTT stage of the tender process. At that time, we will also issue an invoice for the required payment, in accordance with Regulation 4(1) of the Tender Regulations.

Tender Entry Conditions

As set out above, you are required to meet a number of tender entry conditions in order for your project to be included in the first round of tenders in the transitional regime. Most of these tender entry conditions are provided for directly in the Tender Regulations. Where we have exercised our power under paragraph 2(e) of Schedule 2 to the Tender Regulations, this is referenced accordingly. You should note that failure to meet these tender entry conditions may result in cancellation of your project from the tender exercise and delay the appointment of an OFTO. The tender entry conditions are set out below:

1. Information Memorandum

Provide information to populate an Information Memorandum (IM), as set out in Annex 4. Once you have provided the requested information, we will produce a bespoke IM for your project. Prior to us issuing this to qualifying applicants at the QTT stage of the tender process, we will seek your agreement on matters of fact.

2. Data Room and Undertaking

Provide information to populate a data room, using the Data Room Guidelines provided in Annex 5¹². You should note that these have been updated in light of feedback received to the consultation we undertook in May.

In addition to providing this information, we also require you to undertake keep this information up to date¹³. Please note that the information that you provide to us will be disclosed to qualifying bidders along with information from Ofgem and National Grid. To

¹⁰ The disqualification provisions are set out in Regulation 20 and Schedule 7 to the Tender Regulations. You should be aware that in an event of disqualification, the Tender Regulations set out that a developer shall not be repaid (in full or in part) the payment and security provided to Ofgem.

¹¹ An investment grade credit rating is an issuer rating of not less than "BBB-" given by Standard & Poor's Ratings Group or Fitch Ratings Ltd, or is an issuer rating of not less than "Baa3" given by Moody's Investors Service Inc.

¹² We have included instructions to assist the population of the model SPA in Annex 11.

¹³ This is required under paragraph 2(e) of Schedule 2 to the Tender Regulations.

this end, we are seeking your consent to this, and provide a standard form confidentiality consent form in Annex 6 for you to return¹⁴.

3. *Warranty*

Provide a written warranty to Ofgem that the information provided by you in respect of the IM and data room is, to the best of your knowledge and belief, true, accurate and complete in all material aspects. The warranty should be provided as a written statement to us in the format set out at Annex 7.

4. *Transfer Agreement and Undertaking*

Populate the revised model Sale and Purchase Agreement (SPA)¹⁵ provided in Annex 8^{16,17}. We will, thereafter, be contacting individual developers to arrange for one-to-one meetings to agree the project specific terms of the SPA. In accordance with the relevant undertaking set out in Annex 9, we will agree with developers the methodology for maintaining the SPA as the process progresses.

You should note that the model SPA has been updated in light of feedback received to the consultation we undertook in May. You should also note that any services (such as O&M or insurance) and any assets (such as reactive power capability) that you include in the SPA are required to be offered to all bidders on the same terms on a non-exclusive basis, and that there is no compulsion for bidder to accept these through their bids.

5. *Other Undertakings*

In addition to the undertakings referred to above, we also require you to provide a number of other undertakings to us, as set out below:

- a) to undertake to transfer any property, rights or liabilities in relation to the assets to the successful bidder, in accordance with the SPA;
- b) to undertake to respond to queries from Ofgem in a reasonable period during a tender exercise¹⁸;
- c) in the event that you decide to participate (other than as a developer) in the tender process, to undertake to put in place appropriate internal information barriers¹⁹.

All these undertakings are provided in a composite schedule in Annex 9.

User Acceptance Agreement

In order for us to populate a data room (and in respect of the IM and SPA) we require you to provide information to us via our Offshore Electricity Transmission Tendering Portal (the Portal)²⁰. In order to gain access to the Portal, you need to enter into a User Acceptance Agreement. This is provided in Annex 10. Once you have returned the signed agreement, we will provide you with log-in details and other information explaining the requirements in terms of providing the data. At that time, we will also provide you with the required Confidentiality Agreement (between you and qualifying applicants) which will set out terms for maintaining the confidentiality of the information.

¹⁴ This is required under paragraph 2(e) of Schedule 2 to the Tender Regulations.

¹⁵ Referred to as the Transfer Agreement in the Tender Regulations.

¹⁶ We have included instructions to assist the population of the model SPA in Annex 11.

¹⁷ We have included commentary on the model SPA in Annex 12.

¹⁸ This is required under paragraph 2(e) of Schedule 2 to the Tender Regulations.

¹⁹ This is required under paragraph 2(e) of Schedule 2 to the Tender Regulations.

²⁰ This is the electronic tendering tool that we are using to assist us in managing the tender process. It is provided by Bravo Solutions Ltd.

Timetable

The table below sets out the timetable for meeting the requirements set out in this letter:

Requirement	Method of Return	Deadline
Inform Ofgem if you no longer require us to commence a tender exercise	By email*.	By return
Return Portal User Acceptance Agreement	By post**. See Annex 10 for further detail.	5 working days from the date of this letter.
Provide security in accordance with Regulation 6 of the Tender Regulations	Details are provided in Annexes 2 and 3.	15 July 2009
Provide payment in accordance with Regulation 6 of the Tender Regulations	See Annex 3 for further detail.	15 July 2009
Provide information for Information Memorandum	Via Portal. See Annex 4 for further detail.	20 August 2009
Provide information for Data Room	Via Portal. See Annex 5 for further detail.	20 August 2009
Return Confidentiality Consent	By post**. See Annex 6 for further detail.	20 August 2009
Return Warranty	By post**. See Annex 7 for further detail.	20 August 2009
Populate model SPA ²¹	Via Portal. See Annex 8 for further detail.	20 August 2009
Return Undertakings	By post**. See Annex 9 for further detail.	20 August 2009

*All email returns should be sent to offshoretransmission@ofgem.gov.uk.

**All postal returns should be sent to Daniel Baker, Tender Coordinator, Offshore Electricity Transmission, Ofgem, 9 Millbank, London, SW1P 3GE.

If you have any questions regarding this letter, please contact David Gray on 020 7901 0509 or david.gray@ofgem.gov.uk in the first instance.

Yours sincerely,



Robert Hull
Director of Regulatory Services

²¹ We will contact you separately to discuss ongoing engagement with respect to the SPA.