

# Guidance on the Offshore Transmission Owner Licence for Transitional Tender Round 2

## Guidance

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### Overview:

This document provides guidance on the Offshore Transmission Owner (OFTO) licence. The conditions of the licence are a key part of the regulatory framework that underpins the offshore transmission regime. The licence confers a set of obligations, incentives and entitlements on the OFTO.

This guidance note explains how the licence reflects offshore transmission policy by explaining the purpose and mechanics of each licence condition. We aim to aid stakeholders' understanding of the purpose and mechanics of the licence; it is not intended to be a substitute for the licence. If this guidance contradicts any part of the licence then the licence takes precedence.

## Context

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Offshore Electricity Transmission licences are granted through a competitive tender process. The successful bidder in each competitive tender process becomes an Offshore Transmission Owner (OFTO) for a set of transmission assets. These licences confer a set of obligations, incentives and entitlements on the OFTO.

Ofgem launched the first round of competitive tenders (TR1) in July 2009. We launched the first tranche of tenders in the second round (TR2a) in November 2010 and have now reached the Invitation to Tender (ITT) stage for Gwynt y Môr, the final project in TR2a. We have published version 1.4 of the draft generic OFTO licence as part of the tender process. We will be releasing project specific versions of this licence to bidders as part of this ITT stage and to preferred bidders (PBs) as part of the process to close for the Lincs and London Array projects.

This guidance note is intended to help stakeholders understand the mechanisms of the licence and its underlying policy intent. It particularly focuses on the OFTO specific licence conditions, including the revenue entitlement. It is not intended to be a substitute for the licence. If this guidance contradicts any part of the licence, then the licence shall take precedence.

## Associated Documents

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- [Generic Offshore Transmission Owner \(OFTO\) Licence \(Version 1.4\)](#) (October 2012)
- [Updated Proposals for Changes to Ring Fence Conditions and their Impacts](#) (October 2012, reference no. 129/2012)
- [Enforcement Guidelines on Complaints and Investigations](#) (June 2012, reference no. 82/12)
- [Offshore Transmission Owner Regulatory Instructions and Guidance](#) (March 2011, reference no. 26/11)
- [Guidance on the Offshore Transmission Owner \(OFTO\) of Last Resort Mechanism](#) (October 2012)

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# 1. Executive Summary

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The Gas and Electricity Markets Authority, GEMA (The Authority) grants an Offshore Transmission Owner (OFTO) licence to the successful bidder in a competitive tender process. The licence grants a set of obligations, incentives and entitlements upon the OFTO. These obligations, incentives and entitlements are set out in the following parts of the licence:

**The terms of the licence** set out the legal power under which the Authority grants licenses and determines when the licence comes into effect.

**The schedules** specify the area within which the OFTO can participate in electricity transmission and when the Authority may revoke the licence.

**Standard conditions** are obligations for all transmission licensees.

**Amended standard conditions E12 – A1 to A3** adjust the OFTO's revenue stream to account for changes in circumstances between the Invitation to Tender (ITT) bid submission and Licence Grant.

**Amended standard conditions E12 – B1 to B2** define where and how the OFTO should operate its assets.

**Amended standard conditions E12 – C1 to C4** introduce requirements on the way in which an OFTO can be structured and conduct itself.

**Amended standard condition E12 – D1** requires the OFTO to measure and record information and to provide this information to the Authority.

**Amended standard conditions E12 – J1 to J10** set out the OFTO's revenue rights and incentives.

This guidance note explains the purpose and mechanics of these parts of the licence.

## 2. Introduction

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### Background

- 2.1. The Authority grants an OFTO licence to the successful bidder in a competitive tender process. The licence grants a set of obligations, incentives and entitlements upon the OFTO. This includes the right to a 20 year regulated revenue stream in return for providing transmission services.
- 2.2. Preferred bidders have been appointed for the Lincs and London Array projects; the first two projects in the second transitional tender round (TR2a). The ITT stage for the final TR2a project began in October 2012.
- 2.3. To support the tender process, this guidance note provides an explanation of the components of version 1.4 of the licence for participants in the tender process and other interested stakeholders. Alongside this guidance note, we have published version 1.4 of the generic licence. Project specific versions of this licence will be granted to the successful bidders in the current tender round.
- 2.4. The licence broadly comprises two parts. One part sets out the standard conditions which apply to all transmission owners. The other part sets out the conditions which are modified to meet the circumstances of each transmission business. The modified conditions may be "amended standard conditions" or "special conditions". In addition there are Terms of the Licence enabling an OFTO to participate in the transmission of electricity.

### Standard Conditions

- 2.5. The standard conditions are obligations which apply to all transmission licences. Sections A and E of the standard conditions set out the obligations applicable to OFTOs.

### OFTO Specific Conditions

- 2.6. We may need to modify the conditions of a licence to meet the circumstances of the specific transmission business. For example, for OFTOs we need to amend certain standard conditions to incorporate individual revenue entitlements. The Authority has powers under the Electricity Act 1989 (the Act) to grant and modify licences.
- 2.7. The Authority may modify licences under sections 11A to 11F or under section 8A of the Act. The Act requires us to consult ahead of making any changes to licences under either approach.

### **Licence modification under sections 11A to 11F of the Act**

- 2.8. Sections 11A to 11F of the Act allow us to modify the standard conditions and existing amended standard conditions of each OFTO licence once the licence has been granted.
- 2.9. Using powers under sections 11A to 11F of the Act, new OFTO specific licence provisions can be incorporated into each OFTO licence as “special conditions”. We can exercise this power to incorporate OFTO specific revenue provisions following Licence Grant.
- 2.10. Under sections 11A and 11B of the Act the Authority must publish a notice of proposed licence changes. The licence changes are then open to consultation for no less than 28 days. The Authority then considers all consultation responses before deciding whether to implement the licence changes. If the Authority then decides to modify the licence it publishes a notice of its decision to proceed with the modifications. The licence modifications come into effect no earlier than 56 days after publication of this notice. Affected parties have the right to appeal during the 20 days following the publication of the decision to proceed with the modifications.

### **Licence modification under section 8A of the Act**

- 2.11. Section 8A of the Act allows us to modify the standard conditions of each OFTO licence at licence grant. These modifications can only be consulted on prior to Licence Grant.
- 2.12. Using powers under section 8A of the Act, the OFTO specific provisions can be incorporated into each OFTO licence as “amended standard conditions”. We expect to exercise this power to propose modifications to the standard conditions of each OFTO licence in order to incorporate the OFTO specific provisions in the licence at the time of grant. This approach provides certainty to each offshore transmission licensee and their funders regarding their revenue entitlements from the day the licence is granted, allowing them to achieve financial close.
- 2.13. Under section 8A of the Act the Authority must publish a notice of the proposed licence changes. The licence changes are then open to consultation for no less than 28 days. The Authority then considers all consultation responses before deciding whether to implement the licence changes at Licence Grant.

### **Development of the Licence for TR2**

- 2.14. We have reviewed the OFTO licence in light of lessons learnt from TR1 to ensure that the licence best meets the intent of the offshore transmission regime. Version 1.4 of the OFTO licence and this licence guidance apply

solely to TR2a projects. Equally not all of the adjustments made to the TR1 licences on a project specific basis are considered necessary for the TR2a licence.

### **The Availability Incentive**

- 2.15. The availability incentive encourages OFTOs to maintain their transmission assets in good working order. If OFTOs make their assets available for the transmission of electricity more than 98 per cent of the time they receive an increase of up to 5 per cent of their annual revenue. If their availability is below 98 per cent they are penalised up to 10 per cent of annual revenue.

#### *Simplification*

- 2.16. The TR2a licence makes the following changes from the TR1 licence to the availability incentive:

- removing variable monthly targets in favour of a flat annual target but keeping a monthly weighting term
- removing the credit banking mechanism and paying out credits earlier

- 2.17. The OFTO revenue model published alongside version 1.2 of the licence is applicable to version 1.4 of the licence<sup>1</sup>

- 2.18. Chapter 9 explains the mechanics of the simplified incentive in detail.

#### *Maintaining the Incentive*

- 2.19. We intend to maintain the requirement for OFTOs to procure financial security sixteen years into their revenue stream. Further clarity on how the security may be called on is provided in chapter 9.

### **Indexation**

- 2.20. Indexation is a technique to adjust a series of cash flows by means of a price index (such as the retail prices index, commonly known as the RPI). Indexation for inflation has the effect of allowing cash flows in different time periods to be compared without the effects of inflation.

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<sup>1</sup> [Illustrative OFTO Revenue model for version 1.2 of the generic OFTO licence](#)

- 2.21. We set out in the decision letter<sup>2</sup> published on 14 July 2011 that we intend to change the approach to indexation in the OFTO licence. We consider that moving towards a PPP/PFI (Public Private Partnership/Private Finance Initiative) approach, which links to a single point rather than a yearly average, could lead to simplified transactions and pass on savings to the consumer.
- 2.22. Further detail on the reasoning behind this approach can be found in the decision letter<sup>1</sup> and chapter 9.

### **Deferred Consideration**

- 2.23. Deferred consideration is the part of the consideration (i.e. the payment from the purchaser to the developer for the transmission assets) to be determined and paid by the purchaser following financial close.
- 2.24. Based on our experience from previous Tender Rounds and on our interaction with bidders on the second transitional Tender Round, we have reviewed our approach to deferred consideration. Ofgem considers that removing the assumption that deferred consideration will be payable following Asset Transfer will allow for greater certainty and deliverability for both the developer and potential OFTOs regarding the amount, timing and funding of the final transfer value.
- 2.25. It is intended that Ofgem will finalise the assessment of costs and determine the final transfer value prior to Licence Grant and the licence has been updated to reflect this position. Although it is anticipated that Ofgem will be able to finalise the cost assessment prior to Licence Grant, there may be exceptional circumstances in which this will not be possible. In these cases Ofgem has the right to determine that a proportion of the indicative transfer value should be paid to the developer on transfer of the transmission assets, with deferred consideration paid thereafter. To do this, a provision to use the Post Tender Revenue Adjustment (PTRA) term post-Licence Grant would be included in the amended standard conditions.

### **Further Issues for Consideration**

#### **Ringfencing**

- 2.26. In October 2012 we published updated proposals for modifications to the 'Ring Fence' conditions in network operator licences<sup>3</sup>. Following this

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<sup>2</sup> [Decision letter on changes to the availability incentive in V1.1 of the OFTO licence](#)

<sup>3</sup> [Updated Proposals for Ring Fence Conditions and their Impacts](#)



consultation any changes to these will be implemented through the transmission owner standard conditions and may impact on OFTOs.

### **Certification of Transmission System Operators**

2.27. On 10 November 2011 the Electricity and Gas (Internal Markets) Regulations 2011 came into force which transpose the third package on the liberalisation of EU gas and electricity markets (the Third Package) into the Act. The measures of the Third Package aim to ensure that the benefits of a competitive energy market can be realised. A key requirement of the Third Package is the ownership unbundling of electricity transmission undertakings from electricity generation, electricity supply, gas production and gas supply undertakings. Under the Electricity and Gas (Internal Markets) Regulations 2011, OFTOs are required to be certified as complying with the ownership unbundling requirements set out in sections 10A and 10D of the Act. More information on the intended procedure for processing applications for certification under the ownership unbundling requirements can be found in the open letter<sup>4</sup>, issued by Ofgem and dated 10 November 2011.

2.28. Changes have been made to the transmission owner standard conditions as a result of the implementation of the Third Package. These changes are laid out in The Electricity and Gas (Internal Markets) Regulations 2011. Changes have been made to the following conditions which are in effect in the OFTO licence post financial close:

- Standard Condition A1 (Definitions and Interpretations)
- Standard Condition E2 (Regulatory Accounts)
- Standard Condition E5 (Provision of information to the Authority)
- Standard Condition E17 (Obligations in relation to offers for connection)

2.29. The Electricity and Gas (Internal Markets) Regulations 2011 also introduce the following conditions in Section E of the standard conditions:

- Standard Condition E22 (General provisions on disclosure of information)
- Standard Condition E23 (Notification of changes that may affect eligibility for certification)

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<sup>4</sup> [Certification of transmission system operators \(TSOs\) under the ownership unbundling requirements of the Third Package](#)



## Guidance on the Offshore Transmission Owner Licence for Transitional Tender Round 2

- Standard Condition E24 (Regional Cooperation)

## 3. Terms of the Licence and Schedules

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### Terms of the Licence

- 3.1. The Terms of the Licence allow the OFTO to participate in the transmission of electricity and specify the date the licence comes into force. They also specify the transmission business specific conditions that the OFTO must comply with.

### Schedule 1: Specified Area

- 3.2. This schedule sets out the specified area within which the OFTO can participate in electricity transmission. This is further limited by amended standard condition E12 - B1, which sets out the transmission system area.

### Schedule 2: Revocation

- 3.3. This schedule describes when the Authority may revoke the licence. The Authority can revoke any licence under a number of specified circumstances. When considering licence revocation, we must consider our statutory duties. Grounds for revocation may include where the OFTO:
- has agreed in writing with the Authority that the licence be revoked
  - fails to comply with certain orders made by a court, Authority, Secretary of State or the Competition Commission. The specific orders are explained in greater detail in the licence
  - is unable to pay its debts in the meaning given in the Insolvency Act 1986
  - has not paid any amount due to the Authority under standard condition A4 or any financial penalty within the due dates, or is unable to pay its debts
  - has ceased to carry on the transmission business or has not commenced carrying on the transmission business within 3 years of the licence coming into force
  - is non-compliant with the obligation to be certified under sections 10A and 10D of the Act.

- 3.4. Further details on enforcement action and licence revocation can be found in Enforcement Guidelines on Complaints and Investigations<sup>5</sup> and on the Ofgem website<sup>6</sup>.

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<sup>5</sup> [Enforcement Guidelines on Complaints and Investigations](#)

<sup>6</sup> [Offshore Transmission Owner Regulatory Instructions and Guidance](#)

## 4. Standard Conditions

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Standard conditions apply to all transmission licensees. Sections A and E apply to OFTOs. Section A sets out definitions and interpretations and clarifies which conditions have effect in the licence. Section E sets out the obligations and entitlements which apply to all OFTOs.

### Section A

- 4.1. The conditions in section A take effect at Licence Grant.
- 4.2. Standard condition A1 sets out the definitions and interpretation of words and expressions used in the licence.
- 4.3. Standard conditions A2, A3, A5 and A6 allow the Authority to direct whether sections B, C, D and E (respectively) have effect in the licence.
- 4.4. Standard condition A4 (Payments by the Licensee to the Authority) obliges licensees to pay a licence fee to the Authority.

### Section B

- 4.5. Section B of the standard conditions sets out conditions that apply to the Scottish TOs and the National Electricity System Operator (NETSO). The conditions in section B are in effect at Licence Grant. The Authority issues a section B direction using powers under standard condition A5 following Licence Grant so that section B does not have effect in the OFTO licence.

### Section C

- 4.6. Section C of the standard conditions sets out the conditions that apply to the NETSO. It does not have effect in the OFTO licence.

### Section D

- 4.7. Section D of the standard conditions sets out the conditions that apply to the Scottish TOs. It does not have effect in the OFTO licence.

## Section E

- 4.8. Section E of the standard conditions sets out the conditions that apply to all OFTOs. These conditions are not in effect at Licence Grant. The Authority issues a section E direction using powers under standard condition A6 following Licence Grant so that they have effect in the OFTO licence.
- 4.9. We do not discuss the standard conditions in any further detail in this document.

## 5. Amended Standard Conditions E12 – A

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### **Amended Standard Condition E12 – A1: Definitions and Interpretation**

- 5.1. This provides the definitions and interpretations for the amended standard conditions.

### **Amended Standard Condition E12 – A2: Market Rate Revenue Adjustment**

- 5.2. This condition establishes the process for adjusting the revenue stream to reflect the difference between market rates assumed for the purpose of the tender revenue stream published as part of the section 8A consultation and the actual market rates that apply on the day of Financial Close. This ensures that the OFTO is not affected by underlying movements in market rates, where this was the basis of its ITT submission. This includes interest rates, retail price index swap rates, gilt rates and index linked gilt rates.
- 5.3. Where the OFTO revenue is affected by market rates, the OFTO is required to prepare a statement outlining the proposed methodology to calculate the market rate revenue adjustment (MRA). This statement must meet the criteria outlined in the licence and be approved by the Authority. At Financial Close, the Authority will determine the value of the MRA, where applicable, in accordance with this methodology statement and direct the value of the MRA term in amended standard condition E12 – J2.

### **Amended Standard Condition E12 – A3: Post Tender Revenue Adjustment**

- 5.4. For some projects it will not be possible for the Authority to complete its final assessment of the costs of developing and constructing the transmission assets sufficiently ahead of commencing the section 8A consultation. For these projects, the section 8A tender revenue stream will be based on an indicative transfer value. This condition establishes the process for adjusting the revenue stream if we finalise the cost assessment after the section 8A consultation commences but before Licence Grant and determine the difference between the indicative transfer value and the final transfer value of the transmission system. This difference in transfer value will determine the post tender revenue adjustment (PTRA) term. The PTRA term will be determined as soon as reasonably practical and, in any event, no later than the date of Asset Transfer.

## 6. Amended Standard Conditions E12 – B

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### **Amended Standard Condition E12 – B1: Transmission System Area**

- 6.1. This condition defines the specific transmission system and location for which the licence is granted. This includes the onshore and offshore connection point, map of the transmission system area and diagram of the transmission system circuit.

### **Amended Standard Condition E12 – B2: Activities Restrictions**

- 6.2. This sets out restrictions on where the OFTO should operate its assets. It prevents the OFTO from undertaking system operator activities and transmission activities outside the area specified in E12 – B2.



## 7. Amended Standard Conditions E12 – C

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### **Amended Standard Condition E12 – C1: Conduct of the Transmission Business**

- 7.1. This condition ensures that no party can gain an unfair commercial advantage due to the conduct of the offshore transmission business. It prohibits OFTOs from sharing premises or resources with the System Operator (SO) or with associated businesses authorised to generate, or supply electricity.

### **Amended Standard Condition E12 – C2: Separation and Independence of the Transmission Business**

- 7.2. Amended standard condition E12 - C2 requires the OFTO to make arrangements so they comply with the obligations in standard conditions E6 (Prohibition of cross-subsidies) and E7 (Restriction on Activity and Financial Ring Fencing) and amended standard condition E12 - C1. It requires the licensee to produce an Authority approved compliance statement describing the arrangements that the OFTO has adopted to comply with the above conditions. The OFTO is also obliged to establish separate boards for the transmission business and associated businesses and must describe the implementation of this obligation in the statement.
- 7.3. The onus is on the OFTO to ensure sufficient information is included in the compliance statement so as to provide the Authority with a full understanding of the systems in place. Whilst the Authority is not responsible for prescribing the content of the statement, as a minimum the Authority expects that:
- a separate compliance statement is required under each licence
  - should the Authority grant a licence to an affiliate or related undertaking of an OFTO and the provision of external services are shared between the licensed businesses, the statement should demonstrate how these services will be allocated to the licensed business to which the statement refers
- 7.4. The Authority can consent to the OFTO not having to comply with some or all of the requirements of the conditions listed in 7.2 above. The decision whether or not to grant consent will be decided on a case by case basis. Where the Authority has granted such consent, the licensee's compliance statement should include the evidence supplied in support of the consent. We would expect to see:

- the OFTO company structure and board structure, including structure diagrams
  - any procedures governing existing or new contractual arrangements with any entity, affiliate or business that is included in any consent
  - any monitoring arrangements to ensure continued compliance
- 7.5. The successful bidder should provide the Authority with their draft compliance statement in advance of Licence Grant in order to ensure the timescales laid down within the licence condition are met. The OFTO should take the necessary steps to ensure their statement can be approved within 30 days of Licence Grant, except where Authority consent provides for a longer period. The OFTO must publish its statement within 7 days of Authority approval.
- 7.6. Should there be any change in circumstances impacting on the validity of the compliance statement, the OFTO shall make all necessary revisions to the statement in order to bring it up to date. The revised statement is not deemed to be effective until it has been approved by the Authority.

### **Amended Standard Condition E12 – C3: Restriction on use of certain information**

- 7.7. This condition prevents the OFTO from sharing information relating to or deriving from the management or operation of the transmission business, which is treated as confidential information for the purposes of this condition. It does not prevent sharing information in specific circumstances detailed in the licence. For example, the OFTO may need to share information with consultants or advisers if arrangements are in place to safeguard the information or if required by law or any competent authority.

### **Amended Standard Condition E12 – C4: Appointment of Compliance Officer**

- 7.8. This requires the OFTO to appoint a compliance officer to ensure compliance with standard conditions E6 (Prohibition of cross-subsidies) and E7 (Restriction on Activity and Financing Ring Fencing) and amended standard conditions E12 – C1 to E12 – C4. The OFTO shall establish a compliance committee to oversee and ensure the performance of the duties and tasks of the compliance officer. These tasks are set out in this condition. The OFTO must ensure that the compliance officer is neither engaged in the activities of the licensee's transmission system nor the activities of any associated business, except in the role of compliance officer, unless the Authority's consent is obtained.

- 7.9. The OFTO must also produce an annual report in a form approved by the Authority that sets out the details of the activities undertaken by the compliance officer in that year, including any investigations conducted.

## 8. Amended Standard Conditions E12 – D

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### **Amended Standard Condition E12 – D1: Offshore Regulatory Reporting**

- 8.1. Amended standard condition E12 - D1 provides for the collection of certain information to allow the Authority to monitor the revenue of the transmission business. It requires the OFTO to measure and record information in line with Offshore Transmission Owner Regulatory Instructions and Guidance<sup>7</sup> and provide such information to the Authority on the relevant dates.

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<sup>7</sup> [Offshore Transmission Owner Regulatory Instructions and Guidance](#)

## 9. Amended Standard Conditions E12 – J

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### Revenue Conditions

- 9.1. The licence entitles OFTOs to earn revenue from providing transmission services. Amended standard conditions E12 – J2 to E12 – J4 define the revenue entitlement for each year running from 1 April to 31 March.

#### Amended Standard Condition E12 – J1: Restriction of Transmission Revenue: Definitions

- 9.2. This provides the definitions for amended standard conditions E12 – J2 to E12 – J10.

#### Amended Standard Condition E12 – J2: Restriction of Transmission Revenue: Revenue from Transmission Owner Services

- 9.3. This condition determines how much revenue the OFTO is entitled to in a given year  $t$ . This is defined as  $OFTO_t$  and it comprises the following terms:

$$OFTO_t = \text{Base Revenue}_t + \text{Pass Through Revenue}_t + \text{Performance Availability Revenue}_t - \text{Correction Factor}_t$$

E12 – J2 determines the value of the base revenue and the correction factor. We discuss pass through revenue and performance availability revenue in the sections on amended standard conditions E12 – J3 and E12 – J4 respectively.

#### Base Revenue

- 9.4. The OFTO's base transmission revenue (base revenue) is the revenue the OFTO is entitled to before adjustments. This is defined as  $BR_t$  and it comprises the following terms:

$$BR_t = (TRS_t + MRA_t + PTR A_t) \times PR_t \times RIT_t$$

- *TRS – Tender Revenue Stream*: this is the revenue established through the tender process.
- *MRA – Market Rate Revenue Adjustment*: this accounts for the difference between rates assumed for the purpose of the tender revenue stream and the market rates on the date of Financial Close, where the OFTO's ITT submission was based on market rates. See paragraph 5.2 for more information.

- *PTRA – Post Tender Revenue Adjustment*: this accounts for the difference between the indicative transfer value for the purpose of the tender process and the final transfer value following the completion of the Authority’s final assessment of costs. See paragraph 5.4 for more information.
- *PR – Proportion of Revenue*: OFTO revenues are paid from 1 April to 31 March of a given year. This term adjusts the OFTO’s revenue for the first and last years of the OFTO’s revenue stream, as these are unlikely to be full years.
- *RIT – Revenue Indexation Term*: This adjusts OFTO revenue for inflation. This is calculated as the percentage increase in RPI from September to September.

### Correction Factor

- 9.5. The correction factor is designed to account for the difference between  $OFTO_t$  (i.e. what the OFTO should receive in a year) and the revenue the OFTO actually recovers (i.e. the OFTO’s forecast of  $OFTO_t$  which they invoice to the NETSO). This is likely to be due to errors in revenue forecasting by the OFTO.
- 9.6. The correction factor adjusts for this difference in the following relevant year. It also adjusts the difference by the Barclays Bank Plc (of any other bank as the Authority may direct) base interest rate to ensure that the net present value of the adjustment is neutral. OFTOs may have an incentive to forecast for large over recoveries of revenue because of the net present value effect. To counter this, there is a penalty interest of 4 per cent on the over-recover revenue if the over-recover is more than 4 per cent. The correction factor is defined in the licence as  $K_t$ .
- 9.7. Possible reasons for differences include:
- human error
  - unforeseen changes to revenue due to changes to the incremental capacity adjustment (discussed as part of amended standard condition E12 – J4)
  - unforeseen changes to revenue due to pass through costs (discussed as part of amended standard condition E12 – J3)
- 9.8. We have designed the availability incentive so that OFTOs will have reasonably accurate information on which to base their forecasts. This is discussed as part of amended standard condition E12 – J4. We do not

anticipate the need to include availability incentive calculations in the correction factor.

### **Amended Standard Condition E12 – J3: Restriction of Transmission Revenue: Allowed Pass-through Items**

- 9.9. This licence condition adjusts the OFTO's revenue for certain costs that may arise but are difficult to predict as part of the bidding process. These costs are passed through to consumers. This mirrors the onshore approach. The revenue adjustment for pass through costs is defined as  $PT_t$  and it comprises the following terms:

$$PT_t = LF_t + RB_t + CEL_t + DC_t + IAT_t + TPD_t + TCA_t + MCA_t$$

- 9.10. The following terms adjust the OFTO's revenues for changes in licence fees, network rates, Crown Estate lease costs and tender fees respectively and are generally self explanatory:

- *LF – licence fee cost adjustment*: to cover licence fee costs
- *RB – network rates cost adjustment*: to cover network rates costs
- *CEL – Crown Estate lease cost adjustment*: to cover Crown Estate lease costs
- *TCA – tender fee cost adjustment*: to cover the fees paid to the Authority for the costs of running the tender process

- 9.11. The remaining terms may require further explanation:

#### *DC – decommissioning cost adjustment*

- 9.12. The OFTO is liable for its decommissioning obligations, which are set by government. The value of the tender revenue stream will be based on the legislative requirements on decommissioning in force during the tender process. However, the legislative requirements could change before the end of the revenue stream entitlement period, which could lead to additional decommissioning costs which the OFTO would not have been aware of during the tender process.

- 9.13. If a change of law requires additional or reduced decommissioning obligations, the OFTO can pass through any increase in efficient costs, if agreed by the Authority.

#### *IAT – income adjusting event*

- 9.14. Certain other events or circumstances that were not predicted at Licence Grant may result in increased or decreased costs or expenses. The licence defines the circumstances which may be considered income adjusting events. An income adjusting event may arise from an event or circumstance that:
- constitutes force majeure under the System Operator – Transmission Owner Code (STC)
  - results from an amendment to the STC
  - is considered and approved by the Authority as an income adjusting event
- 9.15. The increase or decrease in costs and/or expenses must also exceed a threshold. For TR2a projects the threshold is determined on a project basis and is driven by the capacity of the assets.
- 9.16. The OFTO must give notice to the Authority of an income adjusting event. The licence sets out what the notice must contain and the process to be followed.

*TPD – temporary physical disconnection payment*

- 9.17. Under the Connection and Use of System Code (CUSC), the NETSO makes payments to generators if an outage on the National Electricity Transmission System (NETS) interrupts a generator's connection. These are known as Relevant Interruptions. The NETSO can require payment from the licensee to cover compensation costs if the outage is on part of the licensee's system.
- 9.18. Certain outages are identified as Allowed Interruptions in the CUSC and in the bilateral connection agreement (BCA) between the NETSO and the generator. The OFTO is not liable for any payments for outages identified as Allowed Interruptions. There are no formal restrictions on what can be included as an Allowed Interruption in the BCA. We would expect the NETSO would include parts of the NETS where there is not full redundancy, as is largely the case offshore.
- 9.19. This pass through allows the OFTO to recover any compensation costs it is required to make to NETSO.

*MCA – Marine and Coastal Access Act 2009 cost adjustment*

- 9.20. The OFTO may be liable for obligations under the Marine and Coastal Access Act 2009, which are set by government. This pass through provides



protection for any additional costs of complying with additional obligations that did not apply to the OFTO at the time of bidding.

- 9.21. If obligations under the Marine and Coastal Access Act 2009 change, the OFTO can pass through any increase in efficient costs, if agreed by the Authority.

#### **Amended Standard Condition E12 – J4: Restriction of Transmission Revenue: Annual Revenue Adjustments**

- 9.22. This licence condition adjusts the OFTO's revenue depending on performance. It also places obligations on the OFTO to maintain the assets in line with good industry practice. There are two main parts to this condition: the availability incentive and incremental capacity adjustments.

#### **Part A: Transmission System Availability Incentive**

- 9.23. The availability incentive is a combination of obligations and an incentive. The obligations require the OFTO to repair and maintain the assets; the incentive encourages behaviour to maintain asset availability.

#### *Obligations*

- 9.24. This condition requires the OFTO to operate its transmission assets in line with good industry practice and standard condition E15 (Obligation to provide transmission services) to minimise the effect and duration of any transmission outage. Standard condition E15 requires the OFTO to ensure that its assets are capable of transmission.
- 9.25. To complement this obligation, the licence places a number of reporting requirements on the OFTO. It must report to the Authority any service reduction expected to be over 21 days, including details of:
- the effect that it will have on the OFTO's transmission services
  - the cause of the outage
  - the actions taken to repair the outage and minimise its effect
  - the expected timescales for repair of the outage

- 9.26. If overall OFTO availability is below 80<sup>8</sup> per cent in a calendar year (incentive period) or 85<sup>9</sup> per cent over two calendar years then the OFTO must provide the Authority with a written statement setting out how they are complying with the obligation to provide transmission services in accordance with good industry practice.
- 9.27. As with all licence conditions, if the OFTO does not comply with this obligation it could be subject to enforcement action. Licence revocation is the ultimate sanction available to the Authority where other remedies have failed to resolve performance issues.

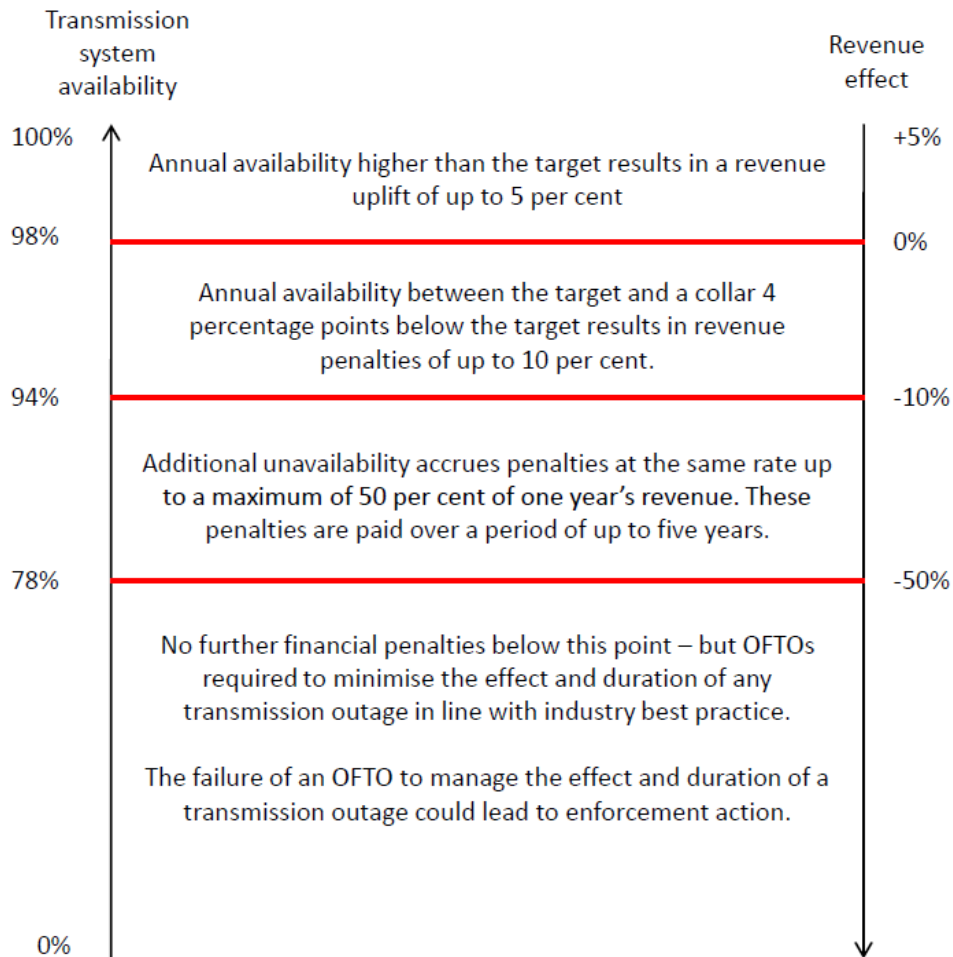
### *Incentives*

- 9.28. The OFTO also faces an incentive to encourage it to maintain availability. The incentive is based on the OFTO's performance against an availability target. For TR2a, the target is 98 per cent. The incentive rewards OFTOs by up to 5 per cent of annual revenue if they exceed the annual availability target and penalises them by up to 10 per cent of annual revenue when they fall below it.
- 9.29. The OFTO collects its maximum annual revenue uplift if it achieves 100 per cent availability. It receives the maximum annual penalty, 10 per cent of annual revenue, if its availability falls to a collar set 4 percentage points below the target of 98 per cent. If availability falls below the collar the OFTO then continues to accrue penalties at the same rate, up to a maximum of 50 per cent of a year's revenue (which occurs at 20 percentage points below the target availability). These penalties are paid over a period of up to five years. During that time additional penalties can be incurred for future payment. However the maximum annual penalty for unavailability remains at 10 per cent of annual revenue throughout the 20 year incentive period.
- 9.30. The diagram below shows how unavailability affects revenue for an OFTO with a 98 per cent revenue target.

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<sup>8</sup> To note: this figure is 75 per cent in TR1 licences.

<sup>9</sup> To note: this figure is 80 per cent in TR1 licences.



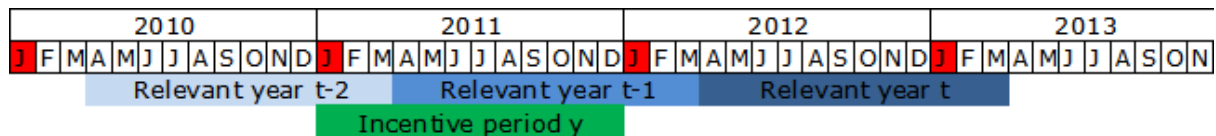
9.31. Offshore generators are likely to have higher revenue at certain times of the year than others. This could be due to higher anticipated prices or a higher quantity of electricity generated. Therefore OTOs are incentivised to place a higher value on maintaining availability in the months that generators value it the most. The incentive is weighted depending on the estimated generation revenues of the connected wind farm. This means the incentive is worth more in months with high forecast revenues and less in months with low forecast revenues.

*Timing of Calculations and Payments*

9.32. Availability performance in a given year does not impact revenue in that year. This is because the NETSO needs enough time to use revenue forecasts to make Transmission Network Use of System (TNUoS) charging calculations. The NETSO requires firm data by 1 January of a year. At this point, there are still 3 months remaining in the time period in which OTOs are paid their annual revenue. To resolve this issue, the incentive defines two different time periods:

1. Relevant year t – this is a year beginning on 1 April of each calendar year and ending on March 31 of the following calendar year. This is the period in which the OFTO is paid its annual revenue.
2. Incentive period y – this is the twelve month period commencing 1 January of relevant year t-2 and ending 31 December of relevant year t-1. This is the period in which availability performance is calculated.

9.33. The relationship between the two is illustrated in the diagram below.



9.34. The following section discusses the mechanics of the availability incentive. Please note in which time period each takes effect.

### **Mechanics**

#### *How is availability calculated?*

- 9.35. Availability is calculated on a monthly basis. It is expressed as the number of megawatt hours (MWh) that the transmission system was capable of delivering in month  $i$  of incentive period  $y$ . This is the Reported System Incentive Performance,  $RSIP_{i,y}$ .
- 9.36. The  $RSIP_{i,y}$  is converted into the Reported Unavailability ( $RU_{i,y}$ ) in month  $i$  in incentive period  $y$  by subtracting  $RSIP_{i,y}$  from the total capacity ( $TC_{i,y}$ ) of the transmission system.  $TC_{i,y}$  is the maximum possible transmission system availability in month  $i$  that the system could deliver. Reported Unavailability is also expressed in MWh.

#### *How is the weighting term incorporated?*

- 9.37. The incentive incorporates the monthly weighting by multiplying the reported unavailability ( $RU_{i,y}$ ) by the weighting term ( $W_{i,y}$ ), given in Annex A of amended standard condition E12 – J4, for that month. The monthly values are then summed to arrive at the total weighted unavailability for year  $y$  ( $WU_y$ ) in MWh.
- 9.38.  $WU_y$  is then divided by  $MA_y$  (the maximum weighted annual availability) to give the percentage total annual weighted unavailability for incentive period  $y$ ,  $TU_y$ .  $MA_y$  is not simply the transmission system capacity multiplied by the number of hours in a year. This is because while the monthly weightings do

average out to 100 per cent over the year, months are not all the same length. Therefore  $MA_y$  is the sum of the maximum weighted availability of each month in incentive period  $y$ . The monthly maximum weighted availability is calculated by multiplying the monthly total capacity ( $TC_{i,y}$ ) by the weighting term for that month ( $W_{i,y}$ ).

*How are the annual and five year caps applied?*

- 9.39. The paid out unavailability ( $PO_y$ ) is the total unavailability in incentive period  $y$  that affects the revenue stream in relevant year  $t$ . It will be between 0 and 6 per cent because at 6 per cent annual unavailability the OFTO reaches the 10 per cent annual revenue impact cap.
- 9.40. If the percentage total annual weighted unavailability ( $TU_y$ ) is greater than paid out unavailability ( $PO_y$ ) the extra unavailability is carried forward up to a total availability cap,  $TCAP_y$ .  $TCAP_y$  is the total annual availability that can affect the OFTO revenue stream over five years. In most years  $TCAP_y$  takes a value of 22 per cent. If one of the five years is a partial year  $TCAP_y$  is given a pro-rata value to reflect this.

*How does the paid out unavailability impact the revenue stream?*

- 9.41. The Availability Incentive term ( $AI_t$ ) is calculated by multiplying the OFTO's base revenue by the availability factor (see paragraphs 9.43 and 9.44) to identify the revenue impact on the OFTO using the following formula:

$$AI_t = BR_{t-1} \times AF_y$$

- 9.42. However, for licences where Asset Transfer occurs between 1 January and 31 March (inclusive) an alteration needs to be made to Availability Incentive equation to reflect the fact that these licences are starting (and finishing) one incentive period later than those licences granted between 1 April and 31 December (inclusive).

For licences granted between 1 January and 31 March,  $AI_t$  is calculated as shown in paragraph 9.41 except:

- in relevant year  $t=2$  where  $AI_2 = 0$
  - in relevant year  $t = 23$  where  $AI_{23} = (BR_{21}/PR_{21}) \times PR_1 \times AF_{23}$
- 9.43. The Availability Factor ( $AF_y$ ) used in the calculation of the Availability Incentive in paragraph 9.41 converts the percentage unavailability into a percentage impact on revenue and takes a value of between -10 per cent and +5 per cent. We achieve this conversion through the following equation:

$$AF_y = (CCAP_y - PO_y) \times (RCAP/PCAP_y)$$

9.44. In this equation:

- $CCAP_y$  is the annual credit availability cap. It is the maximum unavailability that can cause an increase in OFTO base revenue. It is calculated using the following equation:

$$CCAP_y = 2\% \times PR_{(t-1)}$$

except in cases where Asset Transfer occurs between 1 January and 31 March (inclusive), where in incentive period  $y = 23$  it is calculated as

$$CCAP_{23} = 2\% \times PR_1$$

In most years  $CCAP_y$  takes the value of 2 per cent (because target availability is 98 per cent). In partial years it is a pro-rata value.

- $(CCAP_y - PO_y)$  calculates the percentage point difference between the target availability of 98% and the paid out unavailability. It takes a value between +2 and -4.
- RCAP is the annual revenue cap. This is set at 10 per cent.
- $PCAP_y$  is the annual penalty availability cap. It is the maximum unavailability in percentage terms below the target availability (98 per cent) that can cause a negative impact on the OFTO base revenue in any given year. It is calculated using the following equation:

$$PCAP_y = 4\% \times PR_{(t-1)}$$

except in cases where Asset Transfer occurs between 1 January and 31 March (inclusive), where in incentive period  $y = 23$  it is calculated as

$$PCAP_{23} = 4\% \times PR_1$$

In most years  $PCAP_y$  takes the value of 4 per cent. In partial years it is a pro-rata value.

## **Part B: Transmission System Availability Incentive: Supplementary Provisions**

### *Additional Reporting Requirements*

- 9.45. We require OFTOs to submit the monthly RSIP every three months. They must also explain when RSIP falls below target availability in a month.

### **Financial Security**

- 9.46. The licence incentivises OFTOs to continue to maintain their assets across the length of their revenue stream and ensures they do not have an incentive to behave in a manner to avoid future liabilities incurred through the availability incentive. For example, an OFTO may look to avoid these penalties by winding up its business if it experiences a major outage near the end of the revenue stream.
- 9.47. The licence achieves this by requiring the OFTO to procure financial security no later than sixteen years following Licence Grant. The security may be called upon to cover financial liabilities incurred through amended standard condition E12 – J4 (Part A: Transmission System Availability Incentive) which have not been paid through the normal revenue adjustment method. The remainder will be returned to the OFTO at the end of the revenue stream.
- 9.48. As mentioned above, under the regime, availability incentive liabilities are realised through the revenue stream. This is paid by the NETSO. As a result, we expect that the NETSO will be able to call on the security.
- 9.49. The licence allows the potential liabilities to be secured in a number of ways. For example, instruments such as letters of credit or bonds can be used, that can be drawn upon in the event of default to meet the OFTO's future liabilities.
- 9.50. We consider that the licence requirement secures the OFTO's future liabilities. We also recognise that there may be alternative approaches that may also give the Authority comfort that the OFTO's liabilities will be met.
- 9.51. However, we consider that the current approach remains valid and we require bids to be submitted based on the requirements of the draft licence, which obliges the licensee to procure financial security in year 16.

### **Part C: Incremental Capacity Incentive Adjustment**

- 9.52. The NETSO may request that an OFTO make additional capacity available to new or existing generators. If requested, the OFTO is required<sup>10</sup> to offer terms to the SO for providing the additional capacity as long the cost of such additional capacity does not exceed 20 per cent of the original investment cost. The licence includes two mechanisms to compensate the OFTO for providing increased capacity.

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<sup>10</sup> Under the standard licence conditions and the STC.

*Incremental Capacity Utilisation Adjustment ( $ICUA_t$ )*

- 9.53. This applies when the OFTO is able to meet the NETSO's request for additional capacity using existing headroom in its asset's capability. OFTO revenue is increased through a revenue driver. It is set at a level to ensure that parties are correctly incentivised to make capacity available through their existing assets rather than to undertake unnecessary capital expenditure.

*Additional Capacity Investment Adjustment ( $ACA_t$ )*

- 9.54. This applies when the OFTO is best placed to meet the NETSO's request for additional capacity through additional capital expenditure.
- 9.55. In this case the OFTO will submit a notice to the Authority setting out, with supporting evidence, the revenue adjustment that it considers is required to remunerate the costs incurred in providing the additional capacity. The OFTO will include in its cost submission:
- the amount of additional capacity that it is contractually required to provide
  - the capital costs expected to be incurred in providing the additional capacity
  - any corresponding increase in operation and maintenance costs
  - the cost of financing the additional investment in the OFTO's transmission system.
- 9.56. The Authority shall determine the revenue adjustment required to remunerate the efficient costs that the Authority considers to have been reasonably incurred by the OFTO and will notify the OFTO of its determination of the costs. This notice will set the value  $ACA_t$ .

*Which mechanism is used?*

- 9.57. The OFTO's revenue entitlement will be determined by the Authority once the OFTO has entered into an agreement with NETSO to make the additional capacity available. Our determination, and the adjustment mechanism used, will depend on the technical details and specific circumstances of the application for additional capacity.



## Other Conditions

### Amended Standard Condition E12 – J5: Restriction of Transmission Revenue: Adjustments

- 9.58. This condition incentivises the OFTO to correctly calculate its revenues. Firstly, it allows us to monitor recovery of revenues. It requires the OFTO to report any over or under recovery of annual allowed revenue by 3 per cent or more to the Authority. In the next year the OFTO shall not increase its charges unless it has demonstrated to the satisfaction of the Authority that it will not over-recover again in that year. This condition also places similar restrictions on the OFTO if it over-recovers by 4 per cent or more over a two year period.

### Amended Standard Condition E12 – J6: Provision of Information to the System Operator

- 9.59. This condition requires the OFTO to liaise with the NETSO to inform the TNUoS charge setting process. The OFTO must provide best estimates of its revenue and continue to review these estimates and inform the NETSO of significant changes. It also requires the OFTO to inform the Authority of their estimates and any revisions to these estimates.

### Amended Standard Condition E12 – J7: Duration of the Revenue Restriction Provisions

- 9.60. This condition outlines the process that the OFTO must follow if it wishes to disapply part or all of the revenue restriction licence conditions. The OFTO must make a written application for a disapplication in writing to the Authority, specifying those charge restriction conditions to which the request relates.

### Amended Standard Condition E12 – J8: Allowances in respect of Security Costs

- 9.61. The Secretary of State may direct, under section 34 of the Act, the OFTO to provide certain information or advice or to operate in a certain manner during a “security period”. This condition allows the Authority to compensate the OFTO for any reasonable costs that it has incurred due to this operation.

### Amended Standard Condition E12 – J9: Basis of Transmission Owner Charges

- 9.62. This condition requires the OFTO to prepare a statement, approved by the Authority, which sets out its charging methodology for transmission owner service and excluded services. Excluded services include:

- connection to its transmission system
- outage changes

9.63. The OFTO will invoice the NETSO for the items listed above.

### **Transmission Owner Services**

9.64. The OFTO provides transmission owner services, and will invoice the NETSO for these services under the STC (they will invoice these as part of their "TO General System Charge"). The TO General System Charge should equal  $OFTO_t$ .

### **Connection to its Transmission System**

9.65. OFTOs will be remunerated for connection costs through  $OFTO_t$ , so they will recover connection costs through the TO General System Charge. The statement should contain the necessary detail to allow the SO to make a reasonable estimate of the charges for which it will become liable.

### **Outage Change**

9.66. Where an OFTO is requested by the NETSO to rearrange a prearranged outage, the OFTO will be able to charge for efficiently incurred costs associated with this. Details on outage planning are contained in the STC.

### **Amended Standard Condition E12 – J10: Excluded Services**

9.67. The OFTO can provide certain services that are not covered by the revenue restriction conditions. The OFTO can charge for these excluded services at the market rate and they will not be included in the amount covered by their regulated revenue. Outage change is an example of an excluded service.

## Glossary

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### **A**

#### [The Act](#)

The Electricity Act 1989

#### [Asset Transfer](#)

The transfer to the licensee of the transmission assets to which the licence relates

#### [Authority](#)

The Gas and Electricity Markets Authority

### **B**

#### [BCA](#)

Bilateral Connection Agreement

### **C**

#### [CUSC](#)

The Connection and Use of System Code

### **D**

#### [DECC](#)

The Department of Energy and Climate Change

### **F**

#### [Financial Close](#)

The date that the funding arrangements are executed for the purchase of the transmission assets.

### **I**

#### [ITT](#)

Invitation to Tender stage

### **L**

## Licence Grant

This is the date that the licence comes into force.

## **M**

### MRA

Market Rate Revenue Adjustment

## **N**

### NETS

National Electricity Transmission System

### NETSO

National Electricity Transmission System Operator

## **O**

### OFTO

Offshore Transmission Owner

## **P**

### PB

Preferred Bidder

### PFI

Private Finance Initiative

### PPP

Public Private Partnership

### PTRA

Post Transfer Revenue Adjustment

## **R**

### RPI

Retail Prices Index

### RSIP

Reported System Incentive Performance

**S**

[SO](#)

System Operator

[STC](#)

System Operator – Transmission Owner Code

**T**

[TNUoS charge](#)

Transmission Network Use of System Charge

[TO](#)

Transmission Owner

[TR1](#)

The first transitional tender round

[TR2](#)

The second transitional tender round

[TR2a](#)

The first tranche of the second transitional tender round