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all gas and electricity customers*

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Dear Guy,

Indicative Transfer Value for the London Array project and comfort on funding

Introduction

The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2010 provide the legal framework for the process which Ofgem will run for the grant of offshore electricity transmission licences. Regulation 4 of the tender regulations sets 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 the development and construction of the transmission assets. This process will culminate in our determination of the final transfer value for the project.

In our letter of 16 November 2010 we set out the initial transfer value for your project. The initial transfer value was based on London Array's forecast costs for the project's transmission assets. We have since reviewed and analysed the cost information provided by you to calculate our estimate of the economic and efficient costs which ought to be incurred in connection with the development and construction of the transmission assets. This estimate is the indicative transfer value for the London Array project.

This letter sets out:

- the indicative transfer value for the London Array project;
- an overview of the work that has been undertaken to inform the indicative transfer value;
- comfort on the transfer value you will receive once the London Array project is completed (subject to certain conditions); and
- next steps in the cost assessment process.

Background

In our 16 November 2010 letter, we confirmed that the forecast of costs that you provided us on 4 November 2010 for the development, construction and financing of the London Array project would be taken as the initial transfer value for the project. This value of £475.7m was included in the pre-qualification (PQ) document and the preliminary information memoranda for the commencement of the PQ stage for the first tranche of projects in the second transitional tender round. It was also included in the qualification to tender (QTT) document, as we were still reviewing your cost information and undertaking our calculation of the indicative transfer value at that stage.

We describe below the activities undertaken by Ofgem and our external advisers to date to review and analyse the cost information for the London Array project. This has enabled us to calculate an indicative transfer value for the London Array project. We have discussed a number of cost items with London Array and taken into consideration the substantiations that have been provided when setting the indicative transfer value. Our position on these cost items are set out below with our conclusions.

Forensic accounting investigation

Our financial advisers Grant Thornton (GT) have undertaken a forensic accounting investigation to check the completeness, accuracy and correct allocation of costs for the London Array transmission assets. This work is now complete.

The results of the forensic investigation identified a number of cost allocation changes (see table 2) since the initial transfer value submission, and these have been agreed to by London Array.

In addition, our advisors have identified a number of cost items that relate to: duplicate contingencies; interest applied to general development costs; the level of engineering and procurement management costs; and, phase 2 consents. During our discussions with London Array we explained that we were minded to not include these costs in our calculation of the indicative transfer value. We have engaged closely with London Array to understand the rationale for these cost items. We have also reviewed and taken into consideration the substantiations that you have provided against these cost items as well as the September 2011 cost template changes where you have indicated that this is relevant. Our position on each of these cost items is set out and discussed below.

Foreign exchange (FOREX) contingency

GT has queried the application of a foreign exchange (FOREX) contingency to the capital expenditure (CAPEX) cost categories and development costs, to allow for a fall in the value of sterling against the Euro and the Norwegian Krone. This foreign exchange contingency amounts to a total of £8.2m, which is in addition to general contingency provisions of 10% already made within the CAPEX cost categories and development costs.

We have sought clarity from you on the project's approach to hedging to understand the rationale for the FOREX contingency. In response to this, London Array provided in September 2011 a statement from each parent that sets out their approach to hedging. We note that each parent has hedged its position against currency movements, but that the parent entities have not disclosed their hedging rates to each other.

It is our view that, as the parent entities have hedged themselves, we do not consider that it is economic or efficient to include a contingency to cover FOREX losses that may be incurred by the parent entities. We have therefore, removed this cost from inclusion in the indicative transfer value.

Siemens contingency

The GT report identified an additional contingency of 6% that has been applied to the Siemens Transmission and Distribution Limited (STDL) contract for the onshore substation, which amounts to £4.6m. This is in addition to the general contingency provision of £10.9m already applied to the onshore substation costs. We have sought clarity from London Array on the Siemens contingency. We note that London Array describes this as a Siemens technology risk rather than an onshore substation contingency. We also note that the Siemens technology risk accounts for new technological challenges associated with the Siemens contract scope and is a contingency that is included in the contract price. London Array has explained that the technology risk is separate from the contingency that has been applied to the project's costs in the event that overall spend is higher than forecasted. We also note if Siemens do not use the contingency they will keep the remaining amount

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and that London Array has reduced its onshore contingency in its September 2011 cost template on this cost package from 10% to 2% as the contract is almost complete.

We have carefully considered the substantiation provided by London Array and our subsequent discussions on this matter. The explanation provided by London Array suggests that this is an additional contingency which may be called upon by Siemens. Whilst this is separate from the onshore substation contingency, we consider this to be a contingency on top of the existing contingency provisions, which would normally be the means to offset this type of risk. We have therefore decided to remove £4.6m from the indicative transfer value and identify this as a reduction to the project's contingency costs rather than a reduction to the Siemens contract value.

Interest During Construction (IDC) on general development costs

GT identified that London Array have included £1.45m in respect of IDC on £4.2m for historic development costs from 2001 to 2007. Interest was calculated by compounding over 6yrs using an annual rate of 13%. London Array has provided substantiation which provides clarity on the activities that accounted for the historical development costs and confirmed that these relate to the transmission assets. We have accepted London Array's substantiation but have adjusted the interest rate that was applied to 10.8% to reflect Ofgem's October 2011 decision on capping IDC rates. This results in a reduction of £244k which is reflected in the indicative transfer value.

Engineering Procurement and Construction project management costs

Engineering Procurement and Construction (EPC) project management costs have been included as a separate item (in addition to any staff cost elements listed) within each cost category. These costs relate to the project management role undertaken by joint venture partners and is based on an estimated rate of 2% on transmission asset costs (£7.2m). Our consultants considered this level of costs to be greater than expected and we requested further substantiation from London Array.

We note that London Array has reviewed these costs and provided us with a detailed assessment of the activities involved. As a result of this investigation, we note that London Array intends to reduce the EPC costs in an updated cost template to 0.6% of transmission assets which will result in a reduction from £7.2m to £2.1m. We consider this level of cost to be more in line with our expectations for this activity. Given that London Array intends to reflect this reduction in a subsequent cost template we have reduced the indicative transfer value by £5.1m in line with London Array's proposed treatment of this cost.

Phase 2 consents

We have discussed with London Array the £5.6m of expenditure on land consent costs associated with phase 2 of the project. In particular, we asked for clarification on the rationale for securing land consents for phase 2 of the project given that phase 2 financial sign off is yet to be made.

We have carefully considered London Array's position on this matter and we recognise that it may be more efficient for projects at phase 1 to obtain the necessary land consents for subsequent phases of a project. However, we would not expect to see these costs included in a cost assessment for phase 2. Therefore, for the purposes of setting the indicative transfer value we have not removed the phase 2 land consent costs.

Technical review

Using the information we have gathered on transitional projects, Ofgem has undertaken internal benchmarking analysis to understand cost trends emerging across offshore transmission projects and to compare capital expenditure costs between projects to identify

cost outliers. The cost outlier identified by the benchmarking analysis for the London Array project relates to the onshore substation and this has been considered as part of the technical review that has been undertaken on the London Array project.

With support from our technical advisers, KEMA, we have undertaken an initial technical review of the London Array project. This has considered, in particular, the reasoning behind the London Array project's design in order to understand the factors that were taken into account when deciding the design and technical characteristics of the transmission assets. Our interim position on the technical review which has been based on the results of our advisors report, suggests that there are unique and project specific issues driven mainly by the planning process which resulted in a more complex onshore substation design. We have considered these matters carefully and concluded our initial assessment of whether the onshore substation costs are economic and efficient. For the purposes of setting the indicative transfer value we have not made any reductions in relation to your onshore substation costs submission.

We note that your September 2011 cost template submission includes a number of CAPEX cost movements and that the onshore substation costs have been reduced by £10m due mainly to a reduction in contingency costs. Given the scope and range of the cost movements that have been provided, we have not been able to properly scrutinise these cost movements prior to setting the indicative transfer value. However, we intend to investigate these matters further as the cost assessment progresses. In particular, we intend to focus on cost movements across the main CAPEX cost categories.

We will continue to keep under review a range of issues identified in the reports provided by our advisers as we progress the cost assessment process during the preferred bidder stage together with further information you provide to us. Where we have identified issues (for example, those set out in this letter), London Array have the opportunity to provide further information as the cost assessment process continues, and we look forward to discussing these issues with you.

Interest during Construction (IDC)

IDC refers to the cost of financing the development and construction of offshore transmission assets. Industry commonly recognises this financing cost as part of capital expenditure. We consider that for the purposes of the cost assessment, IDC is the rate of interest that ought to be incurred during the development and construction phase. This may not be the same rate that a developer considers they incurred.

In July 2011 Ofgem consulted on the interest rate to be used to calculate the level of IDC for all transitional projects. We published our decision letter¹ and explained that we will apply a capped rate of 8.5% from 1 December 2011. IDC prior to this date will be capped at a rate of 10.8%. This has resulted in a reduction of £17.1m to the IDC relative to the initial transfer value.

Indicative transfer value for the ITT stage

As outlined above, with input from our external advisers, we have undertaken a review of the information that you have provided to enable us to calculate the indicative transfer value for your project. The indicative transfer value for the London Array project is set out in Table 1 below. Table 2 summarises the changes we have made to the initial transfer value since the value was communicated to you in November 2010.

Table 1: Summary of PQ to ITT costs

¹ Decision on interest during construction – 28/11/2011
<http://www.ofgem.gov.uk/Networks/offtrans/pdc/cdr/Cons2011/Documents1/IDC%20decision%20letter%20-%20final%20version.pdf>

Item	Initial Transfer Value at PQ (£m)	Indicative Transfer Value at ITT (£m)
Capital expenditure and development costs	406.8	376.6
IDC	68.9	51.8
Initial/Indicative Transfer Value (with IDC)	475.7	428.4

Table 2: Summary of cost movements – cost accuracy, cost allocation and efficiency

Cost changes arising from GT investigation (accuracy and allocation issues)	Initial TV (Nov 10)	Indicative TV (Nov 11)	Change
Offshore substation	£70.2m	£69.3 m	-£0.9m
Submarine cable supply and installation	£168.3m	£159.9 m	-£8.5m
Land cable supply and installation	£1.4m	£5.4m	+£3.9 m
Onshore substation	£135m	£120.2m	-£14.7m
Connection contract costs	£0m	£8.5m	+£8.5m
Development costs	£31.9m	£31.2m	-£0.6m
Ofgem's allocation and efficiency decisions			
Foreign exchange contingency	-	-£8.2m	-£8.2m
IDC on general development costs	-	-£244k	-£244k ²
Contingency reduction of £4.6m	-	-£4.6m	-£4.6m
EPC project management	-	-£5.1m	-£5.1m
IDC ³	£68.9m	£51.8m	-£17.1m
Total Project Costs	£475.7m	£428.4m	£47.3m

We may amend our calculation of the economic and efficient costs in light of further information that is provided by you during the cost assessment process and our continuing analysis.

September Cost Submission

We note that you submitted an updated cost template in September 2011, with a view to Ofgem basing its analysis on that updated information. That submission contained a number of CAPEX cost movements, which we were unable to scrutinise in sufficient detail to reliably include in our analysis for the indicative transfer value. We understand your disappointment on this point, which you expressed in a recent letter to Ofgem; we will reply separately to that letter in the near future.

In the meantime, we hope to be able to liaise with you closely as the tender process progresses, and we note London Array's suggestion that we conclude earlier specific aspects of the final cost assessment. This is a matter that we will discuss further with London Array in due course.

² Included in IDC reduction

³ Includes -£244k IDC reduction on general development costs

Comfort on funding

Ofgem's intention at this time is to provide developers with comfort on the transfer value that they will receive once their project is completed.

The transfer value you will receive (subject to certain conditions) will be the greater of:

- the Authority's determination of the final transfer value; and
- 75 per cent of the indicative transfer value.

As set out above, our analysis at this time has determined the indicative transfer value to be £428.4 million. Based on this, we can confirm that subject to the conditions set out below, you will receive no less than £321.3 million, being 75 per cent of the indicative transfer value.

This comfort on funding is conditional on the following requirements:

- **Specification of assets being transferred** – that the specification of the assets being transferred to the successful bidder is exactly as specified in the information memorandum;
- **Project completion date** – that there are no significant delays to the completion and transfer of the transmission assets is completed in a timely manner;
- **Cash flow information** – where, for the purposes of calculating interest during construction, we have used historic cash flow information in addition to your projections of future cash flows, such historic cash flow data is validated as part of our assessment of costs;
- **Capital allowances** – the indicative transfer value is calculated on the basis that the purchaser will obtain the full benefit of all available capital allowances. If this is not the case we will reduce the assessment of costs for an amount that reflects the value of the tax benefit retained by the developer; and
- **Further relevant information** – that no further relevant information comes to light to support an indicative transfer valuation of less than £428.4 million, including as a result of a future technical review and forensic investigation. If any of these requirements are not satisfied then we may determine that you will receive less than £321.3 million upon transfer of the assets to the successful bidder.

Next steps

The cost assessment process for London Array will continue to be progressed. Further updates on costs will be provided by you as your project progresses which will be used to inform our assessment of the final transfer value for the London Array project.

If you have any questions regarding this letter, please contact Roger Morgan on 020 7901 0525 (or roger.morgan@ofgem.gov.uk) in the first instance.

Yours sincerely,

Mark Cox
Associate Director, Offshore Transmission