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Dear Hannah,

Consultation – OFTO Tender Round 3

Transmission Capital Partners (TCP) has bid for all OFTOs that have become available in the previous tender rounds, and it is anticipated that we will seek to participate in the forthcoming tender round 3.

We are therefore pleased to have the opportunity to respond to your paper *Consultation on the Generic Offshore Transmission Owner (OFTO) Licence for Tender Round 3* of 7 October 2013.

The annexes to this letter contain our responses to the specific questions raised in your consultation paper. If there is anything that you would like to discuss in more detail please let me know and we would be delighted to assist.

Yours sincerely



Sean Kelly

Encl: Annex – response to specific questions

DETAILED COMMENTS ON CHAPTER 1 **(INDEXATION OF REVENUE)**

Question 1.1: Are there any other options or implications you think we should consider in determining the parameters to use for implementing biddable indexation?

In general we consider Ofgem's approach to be reasonable, and do not believe that there are further options for implementing biddable inflation that need to be considered. However there are two particular issues that we think should be examined in greater detail:

- i) The formulae as currently drafted require that the fraction of MRA that is subject to indexation and the fraction of PTRA that is subject to indexation must be the same (the BI_{RA} factor). We would like to understand what the rationale for this is, and whether there might be certain circumstances where different factors would be justified. It is not obvious to us why the revenue adjustment due to changed market rates and the revenue adjustment due to changed asset valuation need to be indexed in the same way.
- ii) The proposed use of a fixed biddable indexation proportion over the entire 20 year revenue period will generate mismatches, particularly towards the back end, as the cost (and reserve) profile varies over time. Whilst it will be possible to offset this mismatch by entering into a hedging product, this would increase the transaction cost. An alternative, which is likely to be preferable, would be to allow bidders to offer arrangements where the proportion of revenue indexed varies over time in order to perfectly match the debt service.

Question 1.2: Do you agree with the rationale we set out for adopting the parameters identified in paragraph 1.6 as minded-to positions?

We agree that the Social Time Preference Rate is more appropriate than the bidders' IRRs when comparing bids.

We also agree that it is reasonable to use a market-implied RPI rate rather than the Bank of England CPI target rate plus a CPI-to-RPI adjustment factor. We would expect:

- i) That bidders' individual inflation assumptions do not distort the NPV analysis between bids; and

- ii) That the implied inflation would be applied to the real Base Revenue (excluding expected credit receipts) to ensure a fair evaluation process should bidders make different availability assumption.

TCP proposes that Ofgem introduces a separate calculation (e.g. in the financial input sheet) where the parameters below are clearly set out so that bidders' inflation assumptions (which may differ from one another) do not distort the comparison analysis:

- i) The real Base Revenue (BR_t);
- ii) The Indexation Factor (BITRS);
- iii) The Social Time Preference Rate; and
- iv) The Implied inflation.

Question 1.3 Do you agree that using the breakeven inflation, calculated in accordance with the method described in paragraph 1.15, is a suitable market implied inflation figure to use in evaluating biddable indexation bids?

We understand that Ofgem's proposal is to obtain a market-implied inflation rate from the relative yield of 10-year index-lined and conventional gilts. In Ofgem's bid evaluations this single RPI inflation rate value would then be assumed to be constant over the whole 20 year revenue period. We agree that, while not a precise match for market expectations, this approach is simple and should yield a reasonable value for the comparison of bids.

We agree with Ofgem's proposal that it should undertake this calculation and publish the resulting RPI inflation rate value it will use in bid assessment in the Invitation to Tender (ITT) document. This will help to ensure that all bidders understand how their bids will be evaluated. We would like to see this transparency extended - Ofgem should also provide, alongside the ITT document, the spreadsheet used in bid evaluation so that any other factors can be assessed¹.

Question 1.4 Are there any other options we should consider when selecting a market implied inflation figure?

No. We believe the combination of STPR and market implied inflation is sufficient to evaluate bids on a fair and comparable basis.

¹ For instance it is unclear what assumptions Ofgem would make concerning MRA and PTRR when assessing bids.

Question 1.5: Do you agree with the proposed amendment to the calculation of Base Transmission Revenue (BR) to implement biddable indexation?

Subject to our comment in 1.1 above regarding the requirement to index the same fraction of MRA and PTRAs, we agree with the proposed amendments.

DETAILED COMMENTS ON CHAPTER 2 **(REFINANCING OF EXTERNAL DEBT)**

Question 2.1: Are there any other options or implications you think we should consider in determining the parameters to use for implementing a refinancing gain share?

As we have explained in previous consultations, we have concerns that refinancing gain-share arrangements will reduce incentives to recycle capital and therefore may not be in the best interests of future efficiency in the sector. However, we note that the decision to introduce gain-sharing on a basis similar that applied in other sectors has already been made. With this in mind, and subject to the comments below, we broadly agree with Ofgem's approach to sharing of refinancing gains, and do not believe that additional options need consideration.

Question 2.2: Do you agree with the rationale we set out for adopting the parameters identified in paragraph 2.3 as minded-to positions?

We generally agree with the approach taken in paragraph 2.3. In particular we agree:

- That the OFTO should have the responsibility to calculate the gain-share, subject to Ofgem review and approval. This arrangement should minimise unnecessary regulatory work load.
- That the aim should be for the profile of the gain-share tariff reductions to match the profile of any reductions in debt servicing costs.

We note (paragraph 2.11 of the consultation document) that in some cases it might be undesirable for the profile of the gain-share tariff reductions to match the profile of the reductions in debt servicing costs. In these cases Ofgem would calculate a more acceptable profile that would give the same NPV to the shareholders of the OFTO, based on their blended equity IRR. Presumably this would normally be the equity IRR indicated by the financial model submitted with the bid, but in certain circumstances – particularly if the refinancing is taking place many years after financial close – equity IRR expectations may have changed and we would appreciate if Ofgem can confirm that there will be a mechanism whereby shareholders can ask for the equity IRR value to be changed if they can make a suitably justified case for this to happen.

The only example given of a situation where it would not be appropriate for the profile of the gain-share tariff reductions to match the profile of the reductions in debt servicing costs was where this would cause tariffs to rise in certain years. It would be helpful if Ofgem could either (i) confirm that this is the only situation where application of NPV calculations would be necessary, or (ii) indicate the other circumstances where this could occur.

Footnote 14 of your consultation paper states that any annual adjustment of tariffs to reflect the sharing of refinancing gains will be “constant in real terms”. However this is at first sight inconsistent with the suggestion that tariff reductions will be profiled to match the OFTO gain profile.

Question 2.3: Do you think the scope of the refinancing gain share, and in particular the definition of the debt to which it will apply, is appropriate?

We agree with the application of the refinancing gain share solely to “external debt”, that is to say debt which is “provided directly or indirectly by a party who is not a shareholder of the licensee”.

We believe that, if the project is performing below the levels projected in the original Financial Close Base Case financial model, then the investors should be entitled to apply the benefits of refinancing to restore this Base Case projected performance, with gain-sharing only applying to gains above this level.

We also believe that the definition of “Exemptions to the Refinancing Gain Share” needs further revision. We concur with the need for a Financial Distress exemption, but believe that additional exemptions need to be added. For instance, as presently drafted, it appears that any waiver or consent request qualifies as a refinancing. We assume that this is not Ofgem’s intention and that, for example, the standard requirement in bank documents to annually update technical and economic assumptions would not represent a refinancing.

We note that a great deal of historical consultation has occurred in reaching market-accepted “exempt refinancing” positions for PFI/PF2 and that this would be a more workable starting point in order to avoid hair triggers. Such exemptions would include²:

- a) *any Refinancing that was fully taken into account in the calculation of the Unitary Charge (Tender Revenue Stream equivalent);*

² Taken from “Standardisation of PF2 Contracts”, published by HM Treasury, December 2012

- b) *a change in taxation or change in accounting treatment;*

- c) *the exercise of rights, waivers, consents and similar actions which relate to day to day administrative and supervisory matters, and which are in respect of:*
 - (i) breach of representations and warranties or undertakings;*
 - (ii) movement of monies between the Project Accounts in accordance with the terms of the Senior Financing Agreements;*
 - (iii) late or non-provision of information, consents or licences;*
 - (iv) amendments to Sub-Contracts;*
 - (v) approval of revised technical and economic assumptions for financial model runs (to the extent required for forecasts under the Financing Agreements);*
 - (vi) [to the extent OFTO build option applies] restrictions imposed by the Senior Lenders on the dates at which the Senior Debt can be advanced to the Contractor under the Senior Financing Agreements and/or amounts released from the [Escrow Account] during the [Initial Availability Period], each as defined in the Senior Financing Agreements and which are given as a result of any failure by the Contractor to ensure that the construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;*
 - (vii) changes to milestones for drawdown and/or amounts released from the [Escrow Account] during the [Initial Availability Period] set out in the Senior Financing Agreements and which are given as a result of any failure by the Contractor to ensure that construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;*
 - (viii) failure by the Contractor to obtain any consent by statutory bodies required by the Senior Financing Agreements; or*
 - (ix) voting by the Senior Lenders and the voting arrangements between the Senior Lenders in respect of the levels of approval required by them under the Senior Financing Agreements;*

- d) *any amendment, variation or supplement of any agreement approved by the Authority as part of any Qualifying Variation;*

- e) *any sale of shares in the Contractor [or Holdco] by the shareholders or securitisation of the existing rights and/or interests attaching to shares in the Contractor [or Holdco] provided that this paragraph (e) shall, in respect of shares in Holdco, only apply for so long as Holdco holds 100% of the issued share capital of the Contractor];*

f) *any sale or transfer of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements or securitisation of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements; or*

g) *any Qualifying Bank Transaction.*

Additionally, we believe it appropriate that if a refinancing has resulted from the OFTO complying with standard condition E17 (Obligations in relation to offers for connection) to provide additional capacity, then similarly this should be exempt.

Question 2.4: Do you have any views on the proposed licence drafting for the refinancing gain share set out in amended standard condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through items) of the Licence (Appendices 5 and 6)?

TCP believes that there should be a mechanism to waive the 3-month notice of refinancing (new clause 46) in circumstances of financial distress.

TCP recommends that the Licence align with the consultation document (paragraph 2.3.2) – i.e. the Licence should confirm that the refinancing gain share will normally mirror the profile of the gain so that the OFTO does not suffer from a cash flow mismatch.

DETAILED COMMENTS ON CHAPTER 3

AVAILABILITY INCENTIVE - CAPACITY WEIGHTING MECHANISM

Question 3.1: Do you have any views on the drafting of the capacity weighting mechanism in the generic OFTO licence?

The drafting generally appears reasonable, although we note that $C_{x,i}$ should presumably be defined as a fraction rather than as a percentage (which would be a value 100 times larger).

Question 3.2: Do you agree with our rationale for setting the proposed values of a and b at $a=1$ and $b=1.3$?

As presently drafted, we do not consider that the introduction of the capacity weighting mechanism will either drive consumer savings (through more competitive bids) or change the OFTO behaviour in taking outages.

TCP agrees that “a” should remain equal to 1 but would propose to increase the b factor sufficiently so that it could drive a value for money benefit for consumers by giving a substantial improvement to OFTOs’ downside sensitivity analyses.

Our initial analysis shows that a b factor of 2 is likely to translate into benefit passed through to the consumers.

Question 3.3: Do you agree with our proposed approach to use the same values of a and b for all projects in TR3?

We agree with this approach. Most projects currently under construction have similar designs with multiple export circuits, so applying the same values of a and b provides greater consistency.

In the unusual cases where there is only a single export circuit an outage will result in the loss of all capacity; in these cases the values of a and b are irrelevant, so it is reasonable to maximise consistency by applying the standard values of a and b here as well.

DETAILED COMMENTS ON CHAPTER 4 **(FINANCIAL SECURITY)**

Question 4.1: Do you agree with our proposed requirements for the credit rating of the financial institution holding the financial security?

It is unclear to us why there should be a requirement that the institution providing the financial security should be based in a country that is at least “A” rated. It would seem that if a reduction in the creditworthiness of the government in a country was expected to damage the creditworthiness of the financial institutions residing in the country then the credit rating agencies would take this into account and would lower the rating of financial institutions directly.

Question 4.2: Do you agree with our proposal to increase the value of the financial security in line with base transmission revenue?

We agree that indexing the financial security in line with BR_t is reasonable, although it is not clear to us why the size of the financial security relative to BR_t is fixed at 50% in all years and cannot be sculpted to reflect the part of the availability incentive not recoverable through the normal mechanisms (eg arrangements where the security would be sized in line with the liability falling outside the revenue period).

In addition we would welcome further information on the form of this security, who it would be in favour of, and when it can be drawn. At present none of this information is set out in the licence.

Question 4.3: Do you have any views on the licence drafting proposed in Part B of amended standard condition E12-J4 (Restriction of Transmission Revenue: Annual Revenue Adjustment)?

We note that the credit rating requirements do not appear to be set out in the licence. Doing this would reduce the risk to the OFTO that changes in regulatory policy could result in a financial institution unexpectedly ceasing to be acceptable even though the institution had not become less creditworthy.

DETAILED COMMENTS ON CHAPTER 5 **(SF₆ EMISSIONS REPORTING)**

Question 5.1: Do you agree with our decision to introduce a reporting requirement on SF₆ emissions?

The consultation document does not explain why this data is required by Ofgem, given that it is neither an input into revenue incentives nor is it used in ranking of OFTOs. We presume that it is necessitated by European Regulations regarding emissions of greenhouse gasses.

In order to meet this requirement each OFTO will need to:

- Calculate its inventory of SF₆.
- Calculate SF₆ leakage from measurements made during top-ups or when equipment is degassed and gassed.
- Calculate SF₆ emissions due to equipment failure and gas escape.
- Report this data to Ofgem and on its website.

Question 5.2: Do you have any views on the licence drafting of amended standard condition E12-J12 (Sulphur Hexafluoride Reporting Requirements)?

While acknowledging that the sums involved are likely to be small, in view of an OFTOs long-term fixed revenue stream it would be preferable if reporting requirements were fixed rather than being driven by Regulatory Instructions and Guidance which may be periodically changed; to this extent the proposed arrangement seems better suited to transmission companies that have regular price reviews.

Question 5.3: Do you have any views on the proposed approach to reporting emissions?

We agree that measurements, calculations and reporting should be in line with ENA standard S38.

DETAILED COMMENTS ON CHAPTER 6
(OTHER LICENCE CHANGES)

Question 6.1: Do you have any views on the licence drafting changes made to the generic OFTO licence for TR3?

We do not have any views on the other licence drafting changes proposed.