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Dear Sean,

Notice of consultation to modify conditions of the transmission licence proposed to be granted to the successful bidder for the Thanet project

We have today commenced a consultation under section 8A of the Electricity Act 1989 on the proposed modifications to certain standard conditions of the transmission licence that may be granted to Thanet OFTO Limited[1] (the **Potential Licensee**). The transmission licence will be granted to the Potential Licensee if Balfour Beatty Investments Limited (the **Preferred Bidder**) becomes the successful bidder for the Thanet project (the **Project**).

The attached consultation notice is published on our website and sets out details of the proposed modifications, the closing date of the consultation and how to respond. We have posted hard copies to you as well as the Company Secretary of the Preferred Bidder.

We are proposing to add a number of amended standard conditions to the transmission licence that may be granted to the Potential Licensee should the Preferred Bidder become the successful bidder for the Project. These proposed conditions are annexed to the section 8A notice.

In accordance with our statutory requirements and best practice we have brought the proposed modifications to the attention of persons likely to be affected and also provided copies of the notice to:

- The Secretary of State of Energy and Climate Change;
- Consumer Futures;
- The Health and Safety Executive (HSE);
- The Scottish Executive;
- The Welsh Assembly; and
- The Project Developer (Vattenfall).

[1] The proposed licensee entity incorporated by the Preferred Bidder.

Project specific Licence modifications

Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items)

We have added a cost pass through mechanism (the **contingent event revenue adjustment** or **CEA**) to amended standard condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items).

The CEA mechanism is a bespoke cost pass through item for this licence. It allows the Authority to adjust the Potential Licensee's revenue entitlement should costs and/or expenses arise for the following contingent events:

i. the licensee incurring costs in connection with measures to achieve first compliance with Section K Paragraph 7.1 of the STC
ii. any liability of the licensee to repair or replace a subsea cable following an internal cable fault attributable to a 'Root Cause'. The Root Cause is defined to be either the failure to earth the copper tubing surrounding the fibre optic cables during installation or the fact that the outer plastic sheath of the fibre optic cables is not uniformly semiconducting due to a defect in the manufacturing process. This contingent event will only be triggered when two conditions are satisfied. First, the Licensee has been unable to procure insurance without exclusion for either of the above issues at a normal market rate for any affected sections of the subsea cable. Second, the costs incurred, or expected to be incurred, exceed the sums available to the Licensee under the idemnity provided by the developer.

The offshore regime incentivises licensees to manage costs efficiently over a 20 year period but also recognises that licensees may not be best placed to manage such risks where they are not sufficiently within their control. There are therefore a number of pre-defined revenue adjustment mechanisms in the licence that seek to optimally reallocate risk for a small number of known, but unpredictable, factors.

We consider that the most appropriate way of providing the Potential Licensee with a method to recoup costs and/or expenses resulting from the contingent events in connection with this Project, is by including a CEA term in the licence. The use of such a licence adjustment mechanism is necessary in this case for the following reasons:

1. it has not been possible for the Preferred Bidder to resolve or fully mitigate the contingent events by way of commercial agreement with relevant parties or by any other mechanism which would provide an appropriate solution; and

2. the contingent events are both contingent and material, in that:
   (a) it is not certain that the contingent events will materialise during the 20 year revenue period;
   (b) there are uncertain costs which cannot be forecast and which may be incurred by the Potential Licensee as a result of the contingent event; and
   (c) it is likely that if the contingent events did arise they would have a material impact on the costs and/or expenses incurred by the Potential Licensee.

We also note that the Preferred Bidder was not aware, and could not reasonably have been expected to be aware, of the contingent events or the materiality of the contingent events prior to making its Invitation To Tender (ITT) submission.

We further note that, with reference to contingent event (ii), the Preferred Bidder has pursued and secured from the developer a proportionate commercial indemnity agreement to allow for repair or replacement costs in the event of an internal cable fault on the export cable attributable to a Root Cause. However, this indemnity does not fully mitigate the risk

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for the Potential Licensee. Having considered the agreement reached and the associated sums available to the Potential Licensee, we have decided that a contingent event is an appropriate mechanism to allow the Potential Licensee to mitigate any residual risk that may arise from these project specific circumstances, whilst not diminishing their incentive to manage and operate the assets in accordance with good industry practice.

Amended Standard Condition E12-J4 (Restriction of Transmission Revenue: Annual Revenue Adjustments)

We have added additional exclusion limbs to paragraph 9 of amended standard condition E12-J4 (Restriction of Transmission Revenue: Annual Revenue Adjustments) which lists the circumstances under which a transmission service reduction on the Potential Licensee's transmission assets is not included in the calculation of the availability incentive. The inclusion of bespoke exclusion limbs will ensure that the Potential Licensee's revenue is not adversely affected should transmission service reductions occur as a result of certain specific events.

The first group of exclusions are set out in limbs (e), (f) and (g) to paragraph 9 of amended standard condition E12-J4 to exclude from the availability incentive a reduction in transmission system availability (each with its defined limited period) solely as a result of:

e. measures undertaken for the licensee to achieve or resume compliance with Section K Paragraph 2.3 of the STC;
f. measures undertaken in connection with the licensee achieving first compliance with Section K Paragraph 7.1 of the STC as a result of compliance with Section D, Part 1, paragraph 2.2.6.1 of the STC; and
g. measures undertaken to rectify the crossing of the licensee's export cable's phases and/or to rectify inadequate joint and cable support and segregation at specified onshore joint bays.

Limb (e) above relates to possible non-compliance with the STC and ongoing work by the Developer to rectify this. We understand that this work may not be completed before asset transfer and may result in an outage.

Limb (f) above relates to possible non-compliance with the STC. If non-compliance is confirmed, work may be required post asset transfer and may result in an outage.

Limb (g) above relates to the Developer's plans to undertake works on the specified onshore joint bays, which will require outages. We understand that there is a risk that these works may not be completed before asset transfer. However, if the Developer has successfully completed the required works before the licence is granted, we will omit exclusion limb (g) above from paragraph 9 of amended standard condition E12-J4.

These licence modifications are necessary because if any, or all, of these works are required post asset transfer, they may result in outages. The duration of any outages is uncertain and, as a consequence, the resultant financial impact on the Potential Licensee's revenue is unclear, although likely to be material. It is not, on balance, appropriate for the Preferred Bidder to pursue commercial arrangements or other means to fully mitigate these issues, which may have a material impact on the Potential Licensee through revenue losses incurred under the availability incentive.

We also note that the Preferred Bidder was not aware, and could not reasonably have been expected to be aware, of these issues or the materiality of these issues prior to making its ITT submission.

In addition we have added exclusion limb (h) to paragraph 9 of amended standard condition E12-J4 to exclude from the availability incentive any reduction in transmission system availability:

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h. resulting principally from an internal cable fault attributable to a Root Cause, these being the same as defined for contingent event (ii) above.

As noted above, the Preferred Bidder has secured a proportionate commercial indemnity agreement to allow for repair or replacement costs in the event of an internal fault on the export cable attributable to a Root Cause. If such a fault were to occur it may have a material impact on the Potential Licensee through revenue losses incurred under the availability incentive. However, the commercial agreement does not provide for revenue loss by the Potential Licensee. We also note that the Preferred Bidder was not aware, and could not reasonably have been expected to be aware, of this issue or the materiality of this issue prior to making its ITT submission.

The above considerations are consistent with the principle of protecting the Potential Licensee's revenue stream in certain circumstances from outages linked to works that take place post asset transfer.

Having considered all of the circumstances, in particular the extent of the commercial agreement, we have decided that it is appropriate and proportionate to include this bespoke exclusion limb to protect the Potential Licensee against revenue losses that may occur as a result of these project specific circumstances.

Tender revenue stream

Amended standard condition E12-J2 (Restriction of Transmission Revenue: Revenue from Transmission Owner Services) sets out the proposed tender revenue stream for the Project for the purposes of the section 8A consultation (the **s8A TRS**). The s8A TRS is based on the tender revenue stream bid by the Preferred Bidder at the Invitation to Tender (**ITT**) stage of the tender process, which has been updated to reflect further information available to the Preferred Bidder since the date of the ITT submission, including the draft final transfer value for the Project. The s8A TRS assumes that 100% of the draft final transfer value will be paid to the project developer on asset transfer. Details of the transfer value which is reflected in the s8A TRS are set out in the draft cost assessment report for the Project, which is published on our website today (www.ofgem.gov.uk).

If you have any queries regarding the information contained within this letter you should contact Katie Taaffe on 020 7901 7014 or by email offshorelicensing@ofgem.gov.uk

Yours sincerely

Min Zhu
Associate Director, Offshore Transmission

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