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value for all customers*

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Dear Niclas,

**Thanet – Confirmation of Tender Entry Conditions and Further Information on
Cost Assessment and Comfort on Funding**

Introduction

We wrote to you on 8 July 2009 (the July letter) confirming that the Authority was satisfied that Thanet met the requirements set out in the Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2009 (the Tender Regulations) in order to be a Qualifying Project for the first transitional tender process. The July letter also set out:

- the requirements that you need to meet in order for Thanet your project to be confirmed as being included in the first tender round for offshore transmission licences (the Tender Entry Conditions);
- the initial estimate of the economic and efficient cost of developing and constructing the transmission assets associated with Thanet. We nevertheless set out that as a result of any further information that we might obtain from you and our continuing analysis of the information that you have previously provided, we may update our calculation of the economic and efficient costs associated with developing and constructing your project in September; and
- our intention to provide to developers comfort on the transfer value that they will receive once that their project is completed, being (subject to certain conditions) the greater of:
 - the Authority's assessment of the economic and efficient costs associated with developing and constructing the project; and
 - 75 per cent of the Authority's updated estimate of the economic and efficient costs associated with developing and constructing the project.

This letter sets out our decision in respect of the compliance of Thanet with the Tender Entry Conditions, our updated calculation of the economic and efficient costs associated with developing and constructing your project and the comfort on funding as set out above.

Tender Entry Conditions

The July letter set out in detail the Tender Entry Conditions that you would need to meet in order for your project to be included in the first round of tenders for offshore transmission licences. We can confirm that, based on our assessment, the information provided in relation to Thanet meets these requirements. This means that your project is being included with those confirmed as participating in the first round of tenders. We will be setting this out in the documentation that we will shortly be publishing to support the Qualification to Tender stage of the process.

We would remind you that, in accordance with the Tender Entry Conditions, you have provided undertakings with respect to certain issues:

- to provide any new or updated information to the data room, on a weekly basis,
- to prepare the final draft of the project specific Sale and Purchase Agreement (SPA) by no later than the ITT stage of the process,
- to transfer property, rights and liabilities relating to the transmission system in accordance with the final project specific SPA,
- to respond to queries from Ofgem within a reasonable time period, including queries raised by participants during subsequent stages of the tender process¹, and
- where appropriate, to put in place appropriate internal information barriers between the team representing the developer and the team working on a submission for the tender process

It is important to note that a breach of these undertakings may be considered a material breach of the Tender Rules and as such would constitute an event of disqualification under Schedule 7 to the Tender Regulations.

Certain specific issues identified during our consideration of the information provided in respect of the Tender Entry Conditions are set out below.

Information Memorandum

We have enclosed with this letter the final Project Specific Information Memorandum for your project. This document uses the information provided in accordance with the relevant Tender Entry Condition. You will note that we have included you in the disclaimer to this document. We have included this given that the document incorporates information provided by you in accordance with the relevant Tender Entry condition as well as information we have provided based on our, and our consultant's, analysis. It is important to note that this inclusion is entirely separate from and has no bearing upon the warranty you have already given to us on the accuracy and completeness of the information provided.

Data Room

A comparison of the information that you have provided into the data room for Thanet with that information previously given to us in relation to the cost assessment and project qualification process has identified some gaps. In particular, some relevant information previously provided earlier this year has not been uploaded. We consider that this missing information is relevant to bidders and would expect it to be included within the data room. However, for the purposes of evaluating this Tender Entry Condition you will be aware that we have agreed to treat the information previously provided as being satisfactory for the

¹ Any such queries will be collated by Ofgem and provided to the developer in accordance with the process set out in the Tender Rules.

purpose of meeting this Tender Entry Condition. However, you should note that we will require that this information is uploaded to the data room in due course in accordance with the relevant undertaking.

Sale and Purchase Agreement (SPA)

We wrote to developers on 7 August (the August letter) setting out that the use of a project specific SPA provides the appropriate commercial means for transferring the transmission assets and associated rights and liabilities from developer to successful bidder. The August letter also detailed the process we intended to follow to develop these project specific SPAs in the period up to the commencement of the ITT stage of the process. In particular, we set out that we would be releasing these project specific SPAs alongside the Information Memoranda, to enable QTT bidders to provide their considered commercial response with their QTT submissions. The August letter is enclosed for reference.

We are content that you have populated the model SPA with sufficient information for Ofgem to be satisfied that you have met the requirement of the Tender Entry Condition in relation to Thanet. However, we consider that there are aspects of the SPA that need to be clarified before we are satisfied fully with the project specific SPA. We thus consider that it would be premature to release this document to Qualifying Applicants at the QTT stage. Given this, it is clear that the process we set out in our letter of 7 August will need to be modified to reflect the current circumstances. This is set out below.

At this stage, we consider that the dialogue we have had with developers to date means we can release a single document to Qualifying Applicants reflecting the main issues identified across all Qualifying Projects against our model SPA (though it will not refer to Qualifying Projects or developers specifically). We will be making this available shortly. Qualifying Applicants will have an opportunity to consider this information in formulating their QTT submissions. Going forward, we will continue to work with you to refine your first draft project specific SPA ahead of issuing this to Qualifying Applicants in early November, seeking their considered views. This is not a formal part of the tender process but will provide us with an opportunity to understand prospective OFTO concerns with the draft project specific SPAs. Following this, we will engage with you during the remainder of November to finalise the second draft project specific SPA ahead of the commencement of the ITT stage.

This modified process means we will still be able to issue the second draft project specific SPA to Qualifying Bidders at the ITT stage, as part of the data room information. As set out in the August letter, once a Preferred Bidder is selected, the developer and Preferred Bidder for each Qualifying Project will be expected to enter into an executory project specific SPA as part of the process to asset transfer.

For the avoidance of doubt, the SPA is designed to facilitate the transfer of the transmission system and not any other ongoing contractual agreements between bidders and developers, such as O&M agreements. The opportunity for developers to put forward non-binding, non-exclusive proposals for such is initially through the Information Memorandum and in detailed form within the data room.

Cost Assessment

Ofgem, with input from its external advisers, have been reviewing the information that you have provided in respect of Thanet to enable us to calculate the economic and efficient costs in connection with developing and constructing your project.

The July letter set out that we had calculated the costs associated with developing and constructing Thanet at £189 million based on all relevant information available to us with respect to the main capital items (such as electric lines, cables and transformers) of the transmission system and other costs (such as the costs of obtaining consents, overheads and financing costs). However, we also noted that there were specific aspects of the

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information that you are providing (such as system compliance status, system boundary, contracted position, and other costs including tax), that we were continuing to analyse and that as a consequence of this analysis we may update our calculation of the economic and efficient costs associated with developing and constructing your project.

Since July, you have provided further information in relation to Thanet which we have considered in conjunction with the information that you have previously provided. Given all of the relevant information available to us we have updated our calculation of the economic and efficient costs associated with developing and constructing your project at £163.1 million.

We will discuss with you separately to set out the basis of any adjustments that we have made in calculating the economic and efficient cost of developing and constructing your project. In summary, however, our valuation reflects our estimate of costs that ought to have been incurred (including capital expenditure and project contingency) in developing and constructing the transmission assets for Thanet and our key assumptions, including but not limited to:

- that all the transmission assets (and associated rights and liabilities) set out in the Information Memorandum for Thanet are constructed and transferred to the successful bidder, i.e. no subsequent changes in ownership boundary;
- that the transmission assets are energised and commissioned by April 2010 and that the system is compliant with all relevant requirements set out in the industry codes and technical standards;
- that development costs have been incurred efficiently;
- that interest during construction will be remunerated up to the point where transmission assets become operational for the purposes of conveying electricity from the generating station. There is no allowance of post construction financing cost;
- that, for tax purposes, the transmission assets are transferred as a going concern in the hands of the purchaser, where the developer retains tax benefits the transfer value will be reduced; and
- the remaining useful life of the transmission assets and any associated leases is at least 20 years from the date of the transfer.

The principles underpinning our treatment of interest during construction (IDC) and tax are set out in more detail in the section below.

We reserve the right to amend our calculation of the economic and efficient costs of developing and constructing the transmission assets of Thanet in the light of further information that we may obtain from you and our continuing analysis, including for example information relating to our assumptions regarding ownership boundary, completion dates and tax treatment etc.

Once the transmission assets of your project are completed and available for use for the transmission of electricity, and the terms of transfer have been agreed with the successful bidder, we will undertake an assessment of the economic and efficient costs associated with developing and constructing your project.

Treatment of Interest during Construction (IDC)

Our estimate of the economic and efficient cost of developing and constructing the transmission assets of Thanet includes an amount to remunerate the anticipated financing costs that we calculate you will incur during period of construction up to the point of transmission asset commissioning.

We have derived our estimate of IDC based on updated cash flow projections that you provided to us in August. We note that a number of developers have indicated that a higher rate of interest should be applied than those level indicated previously. Since we have not received evidence to support these revised interest rate values we have used the nominal pre-tax interest rate provided by you previously. Nevertheless, we reserve the right in the cost assessment to adopt a different rate of interest based on information that we might subsequently receive.

Treatment of Tax in respect of the SPA

We have obtained advice from our financial and legal advisers and are discussing with HMRC on the tax implications arising from the payments by the purchaser (ie OFTO) to the seller (ie the developer) for the transfer of assets between them required by the SPA.

The SPA which will be used to effect the transfer of assets affects the tax positions differently dependent upon which of two main forms are used to effect the transfer – share transfer of a company in which only the transmission assets reside, or asset transfer of only the transmission assets. The relative ability and speed by which the seller and purchaser (or their groups) can utilise the tax allowances is likely to be one of the main determinants for them of the most effective form of transfer. The model SPA has been designed to be neutral between the two parties in order to allow arm's length negotiations between them on matters which may include any relevant tax clauses relating to the sharing, or otherwise, of any overall benefits including tax.

The model SPA is based upon an asset sale that will be treated as Transfer of a Going Concern in the hands of the purchaser. Such a transfer is tax neutral not only between developer and OFTO on transitional schemes but also between transitional and enduring schemes. However the respective tax positions of the seller and the purchaser may vary, in particular their relative ability to utilise any capital allowances that arise from the expenditure incurred. This may mean that we need to consider an alternative approach to ensure an efficient and economic outcome. If other outcomes emerge during the tender process, we will consider this as part of our assessment of the transfer value.

Comfort on Funding

The July letter set out our intention to provide developers comfort on the transfer value that they will receive once that their project is completed, being (subject to certain conditions) the greater of:

- the Authority's assessment of the economic and efficient costs associated with developing and constructing the project; and
- 75 per cent of the Authority's updated estimate of the economic and efficient costs associated with developing and constructing the project.

As set above, our updated calculation of the economic and efficient costs associated with developing and constructing your project is £163.1 million. Based on this, we can confirm that, subject to the conditions set out below, you will receive no less than £122.3 million, being 75 per cent of our estimate of the economic and efficient costs of developing and constructing Thanet as set out in this letter.

This comfort 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 and executory SPA;

- **Project completion date** – that there are no significant delays to the completion and transfer of the transmission assets;
- **Period of construction financing costs** – the period over which financing costs during construction will be remunerated is up to the expected energisation and commissioning date of the transmission assets for your project;
- **Cash flow information** – where, for the purposes of calculating interest during construction, we have used historic cash flow information (i.e. cash flow up to 1 August 2009) in addition to your projections of future cash flows, such historic cash flow data is validated as part of the final evaluation of the economic and efficient costs of developing and constructing the project;
- **Treatment of taxation** – that the transmission assets are transferred as a going concern for tax purposes; and
- **Further relevant information** – that no further relevant information comes to light to support a valuation of less than £122.3 million.

If any of these requirements are not satisfied then we reserve the right to determine that you will receive less than £122.3 million upon transfer of the assets to the successful bidder.

Next Steps

As you will be aware, we have now published the longlist of Qualifying Applicants for the first round of transitional tenders, and have commenced the Qualification to Tender (QTT) stage of the tender process. This stage of the process closes on 27 October 2009. As a result, there is a significant amount of activity expected over the coming weeks. An overview is provided below.

Confidentiality Agreements and Release of IMs

In order to enable Qualifying Applicants to present comprehensive submissions, we will be releasing the project specific Information Memorandum for Thanet to those Qualifying Applicants that sign and return the Confidentiality Agreement that you provided to us. We will confirm to you the counterparties to this agreement shortly.

Responding to Clarifications during the QTT Stage

We expect that Qualifying Applicants will submit clarifications to us during the QTT stage of the process. As set out above, dependent on the substance of the clarification (for example if it is a technical or contractual clarification about the transmission assets), it may be appropriate that you provide a response to us in a reasonable period, in accordance with the relevant undertaking. We would then provide this to the Qualifying Applicant. Given the timetable for the QTT submissions is four weeks, we would expect that you respond to these clarifications within 3 working days of us sending them to you. This will enable us to respond on an expedient basis to issues raised.

Updates to the Data Room

In addition to responding to clarifications as appropriate, you have also undertaken to update the data room with any new or updated information in relation to Thanet. As set out in the Tender Rules, developers are required to update the data room for their project(s) on a weekly basis as necessary, in particular with respect to any changes in forecast completion or significant changes in the forecast cost to completion of transmission assets.

Final Cost Assessment

Where assets are not completed, the final cost assessment will occur after the asset transfer to the buyer when the developer can notify us that they can assess the outturn

cost of transmission assets with reasonable certainty (i.e. within 1%). It is your obligation to notify us the date you expect this to be so we may undertake this expediently. As part of our assessment in addition to benchmarking by our consultants on the main asset categories we will also employ accountants (or auditors) to undertake a forensic check of some sample cash flows on key contracts and shared costs selected by ourselves. We will be contacting you shortly so this process can be organised with minimum disruption and cost.

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

Yours sincerely,

Robert Hull,
Acting Managing Director, Commercial
Ofgem E-Serve