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Dear Toby,

## **Indicative Transfer Value for the Gwynt - y - Mor (GyM) project and comfort on funding**

### **Introduction**

The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2010 ('the Tender Regulations') provide the legal framework for the process which Ofgem runs 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 includes a number of stages, starting with our confirmation of the initial transfer value, progressing to the indicative transfer value (**ITV**), and culminating in our determination of the final transfer value for the project.

We are currently at the stage where we need to calculate an estimate of the economic and efficient costs that ought to be incurred in connection with the development and construction of the transmission assets for the Gwynt - y - Mor (GyM) project. This estimate is the ITV. This letter sets out:

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

### **Background**

We wrote to Gwynt - y - Mor Offshore Limited (**GYMOL**) on 16 November 2010, confirming that the £305.8m forecast of costs that it provided us on 3 November 2010 for the development and construction (including financing) of the GyM project would be taken as the initial transfer value for the project. This value 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. This figure was also included in the qualification to tender (**QTT**) document, as we were still reviewing GYMOL's cost information and undertaking our calculation of the ITV at that stage. We have now completed the review and analysis of the cost information provided by

GYMOL to calculate the ITV for the GyM project. We describe below both the activities undertaken by Ofgem and our external advisers to date to review and analyse the cost information, and our position on relevant cost items.

### **Forensic accounting investigation & technical review**

Our financial advisers Grant Thornton have undertaken a forensic accounting investigation to check the completeness, accuracy and correct allocation of costs for the GYMOL transmission assets. This work is now complete for the purposes of setting the ITV.

The results of the forensic investigation identified a number of cost changes since the initial transfer value submission; these have been discussed with GYMOL. The main issues arising from Grant Thornton's work are detailed in sections below.

With support from our technical advisers, KEMA, we have undertaken an initial technical review of the GYMOL project. This has considered, in particular, the reasoning behind the GYMOL 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. For the purposes of setting the ITV we have not made any reductions in costs arising from KEMA's review.

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. Where we identify issues (for example, those set out in this letter), we will discuss these with GYMOL and GYMOL will have the opportunity to provide further information as the cost assessment process continues.

### **Ofgem's allocation and efficiency decisions**

We have focussed our review efforts on a number of cost items that relate to: the methodology used to allocate shared costs between generation and transmission; capital expenditure costs; a spare 132/400kV onshore transformer; project contingency; and, interest during construction (**IDC**). We have engaged closely with you to understand the rationale for these cost items. We have reviewed and taken into consideration the evidence that you have provided against these cost items, as well as the recent cost template that you submitted. Our position on each of these cost items is set out and explained below.

#### **(1) Shared cost allocation methodology**

Offshore projects incur costs on services during development and construction that are shared between transmission and generation. Our approach is to request that developers propose a suitable metric to split the shared cost. Where no suitable metric can be agreed, our default metric is to use the direct equipment cost of the transmission assets as a proportion of the direct equipment costs for the project as a whole. The advantages of this metric are that it is easy to calculate and it is not reliant on other cost allocation metrics (whereas the ratio of overall costs for transmission versus those for the project as a whole is reliant on shared cost allocation decisions).

Grant Thornton has examined, amongst other things, the methodologies adopted by GYMOL for allocating such costs between generation and transmission. Grant Thornton notes that the project has revised its allocation methodology on three occasions. For the ITV you have used two cost allocation ratios for allocating the different categories of shared costs, referred to as cost allocation keys 1 and 2.

- Cost Allocation key 1: 25%, based upon expected proportion of overall project resourcing time that will be spent on the transmission assets. This is proposed to be applied to costs up to and including December 2010.
- Cost Allocation key 2: 19.9%, based upon the proportion of total wind farm costs

that will be spent on transmission assets. This is to be applied for all costs post December 2010.

We have discussed the calculations underlying both of these cost allocation keys. We understand that, in calculating cost allocation key 2:

- you have only taken into account asset costs up to December 2013, as the transmission asset costs are expected to be incurred only up to that date; and
- a further £307m of windfarm costs which are expected to be incurred during 2014 are omitted from cost allocation key 2.

#### Ofgem's position for the ITV

We consider that your calculation of cost allocation key 2 was inappropriate because it does not account for the project costs post December 2013, and consequently it overestimates the proportion of overall project costs to be allocated to transmission. We have therefore applied the default metric (i.e. the direct equipment costs of the transmission assets as a proportion of the total windfarm equipment costs). We note that you have now amended the associated shared service cost allocation accordingly. This has resulted in costs of the shared services element of the onshore substation being £2.3m less than the costs originally submitted for the purpose of the ITV. The project's development costs have also been reduced by £3.1m. These changes are reflected in your most recent cost template submission. We have incorporated these changes in the ITV as they represent a more efficient means of allocating shared service costs to transmission.

#### (2) Capital expenditure costs

Since the initial transfer value was set, a number of the project's capital expenditure costs have moved. The majority of the capital expenditure movements have been reviewed by Grant Thornton and matched to contracts and variation orders. Grant Thornton has verified a substantial proportion (67.4%) of the submitted capital expenditure costs to the transmission assets based on major project contracts that have been entered into. Grant Thornton has verified other costs to contract options, variation orders, invoices or working schedules along with supporting documentation.

We note that the project's budgeting for the initial transfer value has proven to be inaccurate in certain areas. During our discussions you have explained that the project's original plans to utilise its own vessel during offshore construction ran into difficulties as it became clear that the vessel would not be ready in time. Therefore, the project entered into new contracts with Seaway Heavy Lifting for marine transportation and installation of the project's offshore substation platforms topsides and offshore substation jacket. We note that this multi-vessel approach has led to increases in project management support costs, port lease and licence costs for the project. We note that you consider the project's costs to be firmer at this stage than at the initial transfer value stage and accordingly we do not anticipate further significant increases in capital expenditure costs across the project.

During our discussions it became clear that the Offshore substation boundary for the project incorrectly included 33kV switchgear and the associated commissioning activities. You have agreed that these assets are not transmission assets and have accordingly allocated them to generation. The removal of the cost of these assets, in conjunction with the application of the default shared cost allocation metric, has resulted in a [REDACTED] reduction relative to the project's original ITV submission.

#### Ofgem's position for the ITV

We have considered the capital expenditure movements that have taken place since the initial transfer value was set, and the explanations provided by GYMOL. We conclude that [REDACTED] should be reduced from the asset value for the offshore substation to reflect an

appropriate and efficient cost for the offshore substation boundary and an appropriate reallocation of shared service costs. Based on the evidence presented to us, there is no indication that the remaining capital expenditure costs are not economic and efficient.

(3) Spare 400/132kV onshore transformer

We have discussed your proposals to transfer a spare 132/400kV transformer at a cost of [REDACTED].

You have explained that the transformer acts as a spare for two identical transformers that will be in service at the onshore substation. The two in-service transformers are each rated at 320MVA i.e approximately 50% of overall wind farm capacity. We have sought from you the rationale for purchasing the spare. You have explained that the decision was based on the fact that in the event of failure, the predicted minimum lead time to build an equivalent replacement unit is in excess of one year. The potential lost value of energy during such a period would be significant relative to the cost of the spare, and you consider that National Grid's Security and Quality Supply Standard (SQSS) advocates the acquisition of spares in such circumstances.

Ofgem's position for the ITV

We have considered the evidence you have provided and our subsequent discussions on this matter. We understand the commercial factors underpinning the acquisition of the asset; our view is that this asset is primarily for the benefit of the generator and not the transmission system. The issue of whether it is efficient to include such a spare is dependent on the level of interruption risk and the consequential impacts on the project in the absence of such protection.

For the purposes of the ITV we have included this cost based on our understanding that the costs should then be allocated to the generator through either connection charges or use of system charges. We will keep this matter under review in the run up to setting the project's final transfer value.

(4) Contingency costs

The original costs submitted for the proposed ITV initially set the project's contingency to £22.9m. We have considered the breakdown of the £22.9m contingency to understand how this has been allocated.

We noted that an unidentified contingency sum of £5.8m was included in the £22.9m value. As this was not substantiated against specific assets or activities, we informed you that we would not include this sum in the ITV. We note that the unidentified contingency of £5.8m has now been removed from the project's contingency.

During these discussions, you informed us that the installation of the export cables is likely to be delayed due to bad weather and technical issues. You have since conducted a risk based review of the project to arrive at a new contingency figure. [REDACTED]

Your final contingency submission for the ITV is now £23.9m, an overall increase of £1m to that used for the initial transfer value.

Ofgem's position for the ITV

We consider the reallocation provided by GYMOL to be prudent given the likelihood of anticipated cost overruns related to the installation of the export cables.

We will continue to monitor this cost category as part of our cost assessment and we expect contingency to be zero at the final transfer value stage.

## (5) 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. For the purposes of the cost assessment process, IDC is the rate of interest that ought to be incurred during the development and construction phase.

We have previously consulted with industry as to the appropriate rate(s) to apply for IDC<sup>1</sup>. In reaching our 28 October 2011 decision<sup>2</sup>, we stated that "...for the avoidance of doubt, all projects regardless of tender round will have IDC capped at 10.8 per cent up until 30 November 2011. From 1 December 2011 all projects regardless of tender round will have IDC capped at 8.5 per cent". We also noted that "It was proposed that this cap be applied to existing TR1 projects (to the extent that they are still under construction) and all TR2 projects, i.e. it would be a calendar based cap. Any project requesting a lower forecast IDC than the cap will have their own rate applied to avoid consumers funding a figure above that incurred by the developers".

We have discussed the IDC rate for your project. You have provided us with some documentary evidence to demonstrate the required IDC rate.

### Ofgem's position for the ITV

Consistent with our October 2011 decision we have applied a rate which is the lower of 10.8 per cent and your proposed rate for the period up to 30 November 2011, and then, the lower of 8.5 per cent and your proposed rate thereafter. This gives a reduction of £1.9m to the £43.2m IDC costs submitted. Therefore, the project's IDC for the ITV is £41.3m.

As discussed in our recent meeting, you have not yet provided a complete rationale for the hurdle rate applied. You should note that we will also seek confirmation of the rate and its rationale from the project's joint venture partners. Therefore, our position on IDC may be changed subject to the outcome of further discussions in this respect that we will have in the run up to setting the project's final transfer value.

### **Indicative transfer value for the Gwynt – y – Mor project**

The ITV for the Gwynt - y - Mor project is set out in Table 1 below.

Table 1: Summary of PQ costs to ITT (ITV)

Item	Initial Transfer Value at PQ (£m)	Indicative Transfer Value (£m)
Capital expenditure and development costs	270.3	304.7
IDC	35.5	41.3
Indicative Transfer Value (with IDC)	<b>305.8</b>	<b>346.0</b>

<sup>1</sup> Consultation – Interest During Construction for transitional tender rounds 1 July 2011  
<http://www.ofgem.gov.uk/Networks/offtrans/pdc/cdr/Cons2011/Documents1/Offshore%20transmission%20-%20Interest%20during%20construction%20for%20transitional%20tender%20rounds.pdf>

<sup>2</sup> Decision on interest during construction 28 October 2011  
<http://www.ofgem.gov.uk/Networks/offtrans/pdc/cdr/Cons2011/Documents1/IDC%20decision%20letter%20-%20final%20version.pdf>

Table 2 sets out in more detail:

- In rows 1 to 8, the difference between the costs submitted for the initial transfer value (which was communicated to you in November 2010) and those submitted by you in October 2012 for the ITV; and
- In rows 9 to 11, the amount of the costs submitted which we have not included in the ITV.

Table 2: Summary of cost movements, cost allocation and efficiency decisions

	<b>Project Cost changes</b>	<b>Initial Transfer Value at PQ (Nov 10)</b>	<b>Costs submitted for ITV (Oct 12)</b>	<b>Change from initial transfer value to cost submitted for ITV</b>
1.	Offshore substation	████████	████████	████████
2.	Submarine cable supply and installation	████████	████████	████████
3.	Land cable supply and installation	████████	████████	████████
4.	Reactive Substation	████████	████████	████████
5.	Onshore Substation	████████	████████	████████
6.	Development costs	████████	████████	████████
7.	Contingency	████████	████████	████████
8.	IDC	████████	████████	████████
	<b>Total project costs</b>	<b>£305.8m</b>	<b>£357.8m</b>	
			<b>Ofgem's allocation and efficiency decisions, shown as submitted costs not included in the ITV</b>	
9.	Shared Cost Allocation changes (development costs) (onshore substation)		-£3.1m -£2.3m	Removed from the project's ITV
10.	CAPEX Costs (Offshore substation 33kV switchgear and commissioning costs)		-£4.5m	Removed from the project's ITV
11.	IDC		-£1.9m	Decrease due to CAPEX reduction and application of developer's rate
	<b>Total project costs</b>		<b>£346.0m</b>	

It is important to point out that when setting the project's final transfer value, 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.

### Comfort on final transfer value

Ofgem's intention at this time is to provide you with comfort on the final transfer value which GYMOL will receive once the project is completed.

The transfer value GYMOL 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 ITV.

As set out above, our analysis at this time has determined the ITV to be £346 million. Based on this, we can confirm that subject to the conditions set out below, you will receive no less than £259.5 million, that being 75 per cent of the ITV.

This comfort on final transfer value is conditional on the following:

- **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** – that historic cash flow data we used for the purpose of calculating interest during construction is validated as part of our assessment of costs;
- **Capital allowances** – 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 ITV of less than £346 million, including as a result of a future technical review and forensic investigation.

If any of the above are not satisfied then we may determine that you will receive less than £259.5 million upon transfer of the assets to the successful bidder.

### **Next steps**

The cost assessment process for Gwynt - y - Mor will proceed into the establishment of the final transfer value, based on further updates on costs to be provided by you as the project progresses.

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

Yours sincerely,

**Martin Crouch**  
**Director, Offshore Transmission**