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Dear Duncan,

Indicative Transfer Value for the Westernmost Rough (WMR) project

Introduction

1. The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2013 (the Tender Regulations) provides 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 for calculating the economic and efficient costs 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 (FTV) for the project.

2. We wrote to you on 13 February 2014, confirming that the £199.5m forecast of costs provided to us on 22 October 2013, for the development and construction (including financing) of the WMR project (the Project), would be taken as its initial transfer value. This value was included in the enhanced pre-qualification (EPQ) document and the preliminary information memorandum for the commencement of the EPQ stage for the Project.

3. Dong's WMR project team (the Project Team) submitted a revised cost assessment template (CAT) on 7 April 2014 indicating a project cost of £192.4m. We have now completed the review and analysis of the CAT and ancillary cost information provided by the Project Team to calculate the ITV, i.e. 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 project. This letter sets out:

- an overview of the work that has been undertaken to inform our calculation of the ITV;
- our conclusion of £172.3m as the ITV for the WMR project; and
- the next steps in the cost assessment process.

Overview of work to inform the calculation of ITV

4. To inform the calculation of the ITV, we employed independent consultants Grant Thornton (GT), who undertook a forensic accounting investigation to check the accuracy and completeness of the project's initial costs; in particular, matching proposed CAPEX costs to contract documentation. GT's review commenced in April 2014 and has been subject to delays as additional time has been required to discuss the additional supporting cost information that had to be submitted by the Project Team. A large proportion of these costs were classed as Estimates to Complete. We have explained to you on a number of occasions that we would not accept unsubstantiated costs in the ITV and that additional time should be allowed to focus on substantiating these costs.

5. A follow up meeting took place on 4 September 2014 involving senior management from Ofgem and the Project Team. At that meeting we discussed (i) progress towards closing down the outstanding items identified by the GT forensic review, (ii) the subsequent steps involved in setting the Project's ITV including a review of CAPEX costs that have past the forensic review, and (iii) the implications if the Project's Invitation To Tender start date was delayed beyond mid October 2014. It was agreed that certain cost areas may require us to make a high-level judgement, for example, based on comparison with other projects for setting the ITV, and that further analysis would be conducted in the process of determining the FTV.

6. The Project Team worked closely with GT to close down the outstanding issues. GT's work is now complete and the findings have been shared and discussed in detail with the Project Team. GT incorporated cost increases and decreases agreed with the Project Team since the submission of the revised CAT. It also identified a number of cost items that were classed as unsupported.

7. Before commencing the CAPEX review we required an advanced version of GT's analysis to ensure that we only assess the efficiency of costs that are accounted for. GT's final position was confirmed to us on 26 September 2014. We have set our ITV based on:

- the outcome of the GT review and additional information provided by the Project Team to substantiate costs,
- information contained in the revised CAT, and
- the 25 September 2014 verbal briefing on CAPEX provided by the Project Team.

8. For the Project's FTV, we will continue to keep under review the range of outstanding issues identified in the GT report. Where we identify further issues (for example, relating to those set out in this letter) we will discuss these with the Project Team in the run up to setting the Project's FTV.

Ofgem's decision on allocation and efficiency of costs

9. To calculate the Project's ITV, we have considered the following:

- the findings of the forensic review;
- CAPEX costs, in particular, the submarine cable supply and installation costs, offshore substation platform (OSP) costs and onshore substation costs;
- the approach to allocating share costs (pre-construction electrical costs and ongoing construction and development); and
- the IDC submission for the Project.

10. Our position on each of these issues is explained below.

Findings of the forensic review

11. GT's review noted a number of cost increases and decreases from the initial submission of the revised CAT, that were discussed and accepted by the Project Team. The net impact of these movements is a reduction of £7.4m.

12. GT identified £6.7m of unsubstantiated Project costs. The Project Team has explained that these costs are expected to be incurred and provided partial justification. Due to the incompleteness of such information, GT considered it as insufficient justification for the relevant costs. After the conclusion of GT's work, the Project Team has provided some additional information to Ofgem to substantiate some of these costs.

Ofgem's position for the ITV

13. We have included the reduction of £7.4m in the Project's ITV. We have considered additional information provided by the Project Team in support of some of the £6.7m of unsubstantiated costs. We have included the Force Technology contract costs of £459k in the ITV.

14. This left £6.3m of costs identified by GT as unsubstantiated, for which the justification provided by the Project Team was incomplete. In the absence of robust supporting information for the inclusion of these costs, we have excluded the £6.3m from the ITV. Please note that the Project Team will need to provide a more robust justification if these costs are to be included for review in the Project's FTV.

CAPEX costs

15. When writing to you on the 13 February 2014 to confirm the Project's initial transfer value, we set out concerns regarding the CAPEX elements of the Project's costs and explained how we would take this forward. The delays in finalising the forensic work have significantly delayed our assessment of the Project's CAPEX costs. We met with the Project Team on 25 September 2014 to discuss CAPEX costs. In particular, we focused on the submarine cable supply and installation, OSP and onshore substation costs. We have considered the verbal evidence provided by the Project Team; however, the additional information we expected from the Project Team to inform the ITV was not provided. Our CAPEX review for the purpose of setting the ITV, as agreed in our meeting on 4 September 2014, included high-level judgement for certain cost elements. We will appoint external advisors to conduct more detailed analysis in the run up to setting the Project's FTV.

Submarine cable supply and installation costs

16. We undertook a benchmarking review and compared the Project's costs with those of other projects. We shared and discussed our analysis with the Project Team.

17. To inform our analysis we have also compared the Project's cable supply and installation costs against a model that has been developed by independent consultants. The model takes account of, amongst other things, seabed conditions, cable conductor size, the use of horizontal directional drilling and vessel costs. The review has identified that the Project's combined cable supply and installation costs, once the unsubstantiated costs were removed, are £2.9m higher than the estimate calculated by the model. The excess is primarily in the supply cost, but we note that this comparison is after excluding the

unsubstantiated costs of around £2.5m in the cable installation costs. If these costs are to be fully substantiated, then the cable installation costs could also be in excess of the expected cost level estimated by the model. We will conduct more detailed analysis in the process leading to the FTV decision.

18. We have discussed our analysis with the Project Team who explained these cost levels as follows:

- both the cable supply and installation contracts were competitively procured at a time when market demand had increased and competition amongst manufacturers and installers had not followed suit;
- the contract was considered unattractive for most European based cable suppliers due to the Project's short cable length; and
- limited number of installation contractors had the appropriate vessels and equipment available for subsea cable installation.

19. We requested additional information to support the above explanation, but have not yet received it from the Project Team. In the absence of robust justification we are unable to account for the material difference in the submitted costs and the level that would be expected for a similar project or estimated by the cable model.

Ofgem's position for the ITV

20. In the absence of robust supporting information we are unable to accept the full level of costs submitted. Therefore, we have removed the £2.9m relating to cable supply costs. We intend to keep such costs under review to ensure that accurate outturn positions are reflected in the Project's FTV.

Offshore Substation Platform Costs

21. We discussed the Project's OSP costs with the Project Team and we note that the installation created technical challenges due to seabed conditions, which required additional seabed piles. We also note that the Project's appointed contractor agreed to take on weather risk. Our high-level assessment indicated that the Project's submitted OSP costs (excluding the development costs element) are in the range that would be expected on the basis of similar costs incurred by other projects.

Ofgem's position for the ITV

22. For the ITV we have included the OSP costs as submitted, based on our high-level assessment. To determine the FTV, we will need to conduct a detailed analysis of whether any justification the Project Team can provide is robust enough to support the design and consequential costs incurred.

Onshore substation costs

23. We carried out a benchmarking review of the onshore substation electrical and civil costs. In relation to the civil costs, the Project Team explained that the onshore substation required additional civil works as the structures and buildings are situated on a flood plain and had to be raised to withstand flood conditions.

24. Our benchmarking analysis considered how the Project's onshore substation electrical costs compared with other projects, based on a £m per MW basis. The onshore substation electrical cost of £23.18m equates to a unit cost of £0.11m/MW, compared against the average cost from other projects of £ 0.04m/MW.

25. The Project's electrical costs benchmark on the high side. We requested additional information to support the Project Team's justification, and we expected this to be provided prior to finalising the ITV. However, the Project Team did not provide this.

Ofgem's position for the ITV

26. The Project's onshore substation electrical costs submitted for the ITV are substantially above benchmarked costs for other projects with comparable features. In the absence of robust justification to substantiate these costs we are concerned as to whether the onshore electrical costs are economic and efficient. For the purposes of calculating the ITV we have removed £3.2m from the Project's onshore substation costs. We intend to revisit this issue to understand the final contract position before we take a view on the efficient cost for the FTV.

Allocation of shared costs

27. Offshore projects incur costs on services during development and construction that are shared between transmission and generation. We require developers to submit details of the metrics that are used to split shared costs (including the supporting methodologies). Where no metric is supplied or can be agreed, our default position is to use the direct equipment costs of the transmission assets as a proportion of the direct equipment costs for the project as a whole.

28. The cost submission for the ITV included elements for (i) pre-construction costs and (ii) ongoing construction and development costs.

29. The pre-construction costs included, amongst other things, electrical costs allocated to transmission at a rate of 67%. After we raised questions the Project Team suggested that the rate allocated to transmission should be increased from the 67% to 72%. Further details to justify this allocation has not been provided by the Project Team.

30. At the time of the GT review, all ongoing shared construction and development costs were allocated to transmission at a rate of 25%. After discussion of this allocation, the Project Team suggested that the rate of these costs allocated to transmission should be decreased from 25% to 23.2%. However, the Project Team did not provide the calculations of the resulting costs to reflect this rate.

Ofgem's position for the ITV

31. Having undertaken a preliminary analysis of the limited information provided, and noting the fact that the updated allocation rates still require detailed justification or further calculations to reflect the changes in costs, we have decided to include the original submission on pre-construction costs (67%) and ongoing construction and development costs (25%). We will undertake a more detailed review of the allocation rates in the process to setting the FTV.

Interest During Construction (IDC)

32. We reviewed the Project Team's IDC submission. We discussed the rate applied and noted that the submitted cashflow did not pick up the IDC rate change to 8.0%. This would apply from April 2014. We have adjusted the IDC cashflow and calculated a £400k reduction.

Ofgem's position for the ITV

33. We have removed the £400k from the IDC cashflow. The IDC value for the ITV is £12m. However, we note that the Project Team will submit a revised cost template that

will pick up the adjustments arising from the GT review. We note that the GT changes and the allocation adjustment discussed above may impact on the level of submitted IDC. We will keep this matter under review for the Project's FTV.

Indicative transfer value for the Project

34. The ITV for the Project is set out in Table 1 below. We intend to compile a more detailed overview of Project cost adjustments following receipt of the updated cost template.

Table 1: Comparison of initial transfer value and ITV

Item	Initial Transfer Value at PQ (£m)	Indicative Transfer Value (£m)
Capital expenditure and development costs	187.1	160.3
IDC	12.4	12.0
Indicative Transfer Value (with IDC)	199.5	172.3

Next steps

35. The cost assessment process for the Project will proceed into the calculation of the FTV, based on further updates on costs to be provided by you as the Project progresses. To inform our FTV assessment we intend to work closely with the Project Team. The process will involve the following:

- An ex-post forensic review and closing down the issues identified in this letter, in particular, the unsubstantiated costs. If robust justification is not provided these costs will not be included in the FTV; and
- a detailed review of the Project's CAPEX costs that have passed the forensic review. This will be assisted by independent technical consultants.

36. 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,

Min Zhu
Associate Director, Offshore Transmission