

To:

**Chief Operating Officer
Blue Transmission London Array Limited
The American Barns
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Warwickshire
CV35 0AE**

Determination in relation to a notice of an income adjusting event from Blue Transmission London Array Limited

On 19 June 2015, the Authority received a notice (the Notice) from Blue Transmission London Array Limited (the Licensee) in respect of an event which the Licensee considers to be an income adjusting event (IAE). The Authority has determined that the event does not constitute an IAE for the reasons given in this letter. In the letter we also explain the details of the event set out in the Notice, provide a summary of the income adjustment event provision and describe the process we have followed to reach the Authority's determination.

Background

The Licensee is the holder of an offshore electricity transmission licence, granted on 9 September 2013 under section 6(1)(b) of the Electricity Act 1989 (the Licence). The Licensee provided the Notice to the Authority pursuant to paragraph 14 of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) of its Licence (the Condition), in respect of an increase in costs and/or expenses incurred by the Licensee which it considers were caused by an IAE.

The Notice and grounds for IAE claim

In accordance with paragraph 16 of the Condition, the Notice provided by the Licensee gave particulars of:

- a) the event to which the Notice relates and why the Licensee considers the event to be an IAE;
- b) the amount of any change in costs and/or expenses that can be demonstrated by the Licensee to have been caused by the event and how the amount of these costs and/or expenses has been calculated;
- c) the amount of any allowed revenue adjustment proposed as a consequence of that event and how this allowed revenue adjustment has been calculated; and
- d) any other analysis or information which the Licensee considers sufficient to enable the Authority and the relevant parties to fully assess the event to which the Notice relates.

In summary, the Notice relates to scour that has occurred at the location where the four HV Export Cables cross a third party cable (the Cable Crossing), which had the potential to affect the integrity of the cables as well as, possibly, the integrity of the rock berm installed to protect the cables (the Event). The Cable Crossing was designed and constructed by the developer of the wind farm prior to the transfer of the transmission assets to the Licensee. In summary, the Licensee considers that the Event has arisen due to the Cable Crossing not being designed and constructed in accordance with good operating practice and that, if certain matters had been addressed in the design, it is likely the Event would not have occurred.

As a result of the Event, the Licensee considered that urgent remedial work was necessary and that further remedial work may be necessary. The Notice relates to the costs and/or expenses of the remedial works performed by the Licensee in the financial year 1 April 2014 to 31 March 2015 (relevant year t_3) (the Relevant Financial Year). The Licensee considers that the Event is an IAE pursuant to sub-paragraph 15(c) of the Condition because such an event and the consequential costs and/or expenses were not reasonably foreseeable at tender due diligence or at financial close when the revenue calculations were fixed.

The Notice set out that there has been an overall change to the costs and expenses of the Licensee of £1,755,829.39 for the Relevant Financial Year as a result of the Event. In the Licensee's response of 10 May 2016 to our further request for information, the Licensee clarified that the overall change to its costs and expenses arising from the Event are now £1,732,564.88.

Pursuant to paragraph 17 of the Condition, the Authority requested that the supporting evidence provided by the Licensee in the Notice be supplemented with additional information to enable the Authority to assess whether an IAE had occurred and the amount of any change in costs and/or expenses caused by the Event. This occurred on four occasions:

- a) 24 August 2015; the Licensee responded to this request on 18 September 2015
- b) 15 December 2015; the Licensee responded to this request on 15 January 2016
- c) 13 April 2016; the Licensee responded to this request on 10 May 2016
- d) 4 August 2016; the Licensee responded to this request on 8 August 2016

Publication of the Notice and consultation

Paragraph 19 of the Condition requires the Authority to publish the Notice, excluding any confidential information, following its receipt. Paragraph 21 requires that the Authority consults with the Licensee and such other persons as it considers desirable before making its determination.

The Licensee considered that the details of the Event and all financial costs and expenses were confidential information due to the Licensee's ongoing commercial discussions with the contractor responsible for the design and construction of the Cable Crossing.

Under paragraph 20 of the Condition, we have the discretion to determine the confidentiality of information in the Notice by balancing the need for disclosure to enable relevant parties to fully assess the Event against the risk of seriously prejudicially affecting the interests of a person to which it relates. In the specific circumstances of this Event, the Authority agreed that the publication of any information about the Event might seriously prejudice the interests of the Licensee in respect of its commercial discussions.

As the commercial discussions had a direct bearing on the amount of costs ultimately borne by the Licensee in respect of the Event and therefore subject to the claim under the Licence, we considered it appropriate to delay publication of the Notice on grounds of confidentiality until such time as the discussions had concluded. The discussions were protracted in nature and the Licensee notified the Authority that agreement had been reached with the contractor on 6 July 2016. The Authority published the Notice on 12 August 2016.

In accordance with paragraph 21 of the Condition, the Authority has consulted with the Licensee in relation to its determination and has considered the representations made by the Licensee in reaching the decision set out in this letter. In the period from receipt of

the Notice until 6 July 2016, the Authority did not consider it appropriate to consult with other parties due to the confidentiality of the matter. In any event, and in the period following 6 July 2016, based on the facts and circumstances of this Event the Authority did not consider it desirable to consult with any other party before making its determination. This was on the basis that the fact-specific nature of the claim limited the likelihood that any other party would have any additional information in this case that might be relevant to our decision on whether an IAE had occurred and, if so, the proposed level of adjustment.

Income Adjusting Events

Paragraph 15 of the Condition defines what constitutes an IAE, as follows:

An income adjusting event in relevant year t may arise from any of the following:

- a) an event or circumstance constituting force majeure under the STC;*
- b) an event or circumstance resulting from an amendment to the STC not allowed for when allowed transmission owner revenues of the Licensee were determined for the relevant year t; and*
- c) an event or circumstance other than listed above which, in the opinion of the Authority, is an income adjusting event and is approved by it as such in accordance with paragraph 21 of this licence condition, where the event or circumstance has, for relevant year t, increased or decreased costs and/or expenses by more than £1,000,000 (the "STC threshold amount").*

As noted above, the Licensee claims that the Event is an IAE pursuant to sub-paragraph 15(c) of the Condition (Limb (c)).

Under Limb (c), the Authority may approve any other event or circumstance not covered by sub-paragraphs 15(a) and (b) which, in the opinion of the Authority, is an IAE. The Condition does not expressly set out any particular qualifying criteria for determining whether an event constitutes an IAE under this limb. In assessing the claim under Limb (c) we have therefore construed Limb (c) in the context of the two preceding limbs and have considered, in the light of the Licensee's representations and our statutory duties, the relevant general policy principles behind the offshore regime and the Condition.

It is an overarching premise of the generator-build OFTO regime that the developer of the windfarm bears the risks associated with construction of the transmission assets, such as increased costs from construction overruns and the failure to complete the assets on time during the construction phase. In contrast, the OFTO is responsible for owning and operating the transmission assets from the point of asset transfer, and for the associated risks arising from ownership of the assets, such as changes to costs of operating and maintaining the assets over the 20 year revenue period. The offshore regime incentivises licensees to manage costs and risks efficiently over that period, but also recognises particular circumstances where licensees should not have to bear the consequences of such risks arising.

As stated in our Guidance on the Offshore Transmission Owner Licence (17 September 2013), the pass through Condition in the OFTO licence, of which the IAE term forms part, adjusts the OFTO's revenue for costs that may arise but are difficult to predict as part of the bidding process (see paragraph 9.9). The Condition contains a number of defined events or circumstances which permit revenue adjustments, such as changes to costs associated with the Crown Estate lease. The IAE term allows adjustments for certain other events or circumstances that were not, and could not have been, predicted at licence grant.

In the context of the Offshore regime, which seeks to provide long-term visibility on transmission costs through a competitive procurement process, and considering the

drafting of paragraph 15 of the Condition, the IAE mechanism should be used only in respect of events that are exceptional in nature. This is reflected in the strict principles we have applied to considering a claim under Limb (c) (see below).

Limb (c) of the Condition

In assessing whether an event or circumstance is an income adjusting event under Limb (c), we have considered the balance of risk and whether the Licensee is the most appropriate party to manage the risk of the event or absorb the impact. To determine this, we have considered the extent to which the Licensee was, or should have been, in a position to foresee the event or circumstances and the level of control it had to mitigate the impact of such event.

We considered the following factors:

- whether the risk of damage of that type was reasonably foreseeable (even if the particular way in which the damage has occurred may not have been);
- whether there are nevertheless exceptional factors in the relevant case that mean that the event or circumstance, or its consequences, could not have been reasonably foreseeable;
- whether the Licensee knew of the event or circumstance before it arose or ought to have known of it; and
- the ability of the Licensee to manage the risk or impact by putting in place and pursuing risk management arrangements such as insurance, commercial recourse against third parties and/or operating practices.

We consider that such an approach is consistent with the overarching design of the Offshore regime as described above, and with the Authority's statutory duties, in particular its principal objective to protect the interests of existing and future consumers in relation to electricity conveyed by transmission systems. For example, we do not consider it to be in the interests of consumers to have passed through those costs arising from a type of damage that was (or should have been) foreseeable to a bidder/OFTO, solely because the precise damage of that type that occurred was not foreseeable; we therefore consider it appropriate to adopt a narrower, rather than a broader, construction of Limb (c) in this regard. Such an approach also seeks to ensure that bidders are properly incentivised to conduct due diligence in respect of the assets, to put in place appropriate commercial arrangements prior to asset transfer and to pursue any relevant third parties who may be liable (such as developers, manufacturers, installers, and insurers).

Determination on whether the Event constitutes an IAE under Limb (c)

The Authority has decided that the Event referred to in the Notice does not constitute an event or circumstance that is an IAE pursuant to sub-paragraph 15(c) of the Condition¹. The reasons for this decision are as follows:

- (a) The Authority considers that risks arising from damage to the seabed as a result of the normal erosive action of the sea, such as scour, are reasonably foreseeable risks associated with operating the assets over the 20 year revenue period. In relation to the Event set out in the Notice, we note that the relevant location is known to have very strong currents and tidal flows and, prior to licence grant, the Licensee had identified issues associated with the deterioration of the rock berms on another part of the cable. In response to a request for clarification as to how the costs associated with the Event relate to any insurance arrangements, the

¹ For the avoidance of doubt, the Authority also does not consider that the Event constitutes an IAE under sub-paragraph 15(a) or (b) of the Condition

Licensee explained that its insurer had "*confirmed that the effect of the current and wave movements are not an insured peril as this is considered to be a normal action of the sea*"² (and also confirmed that the seabed itself was not insured, given that it does not form part of the works or assets).

- (b) The Licensee has raised the argument that the scour issue has arisen because the Cable Crossing was not designed correctly by a third party, citing concerns about (i) the location of the rock berms, (ii) the separation between them, and (iii) their orientation. We do not consider it necessary in this case to form our own view on whether the design was defective such that it caused the scour. Even if that were the case, we consider that such damage arising from the actions or inactions of parties involved in undertaking the design, construction or operation of the transmission assets is the type of risk that is reasonably foreseeable to a licensee and should be within their contemplation when they submit tenders under the generator build regime, however it may materialise. In particular, it is our understanding that the presence of a rock berm on the sea bed will cause some scour, particularly in a location with strong currents and tidal flows, and that if that rock berm is badly designed it may cause a greater degree of scour.
- (c) Similar to any other transaction involving a purchase of assets, the licensee enters into such transactions with an awareness that they are assuming any risks arising from damage or defects that they have not been able to discover through their due diligence. The Offshore regime was not designed to insulate licensees from all such risks.³ When taking on assets under generator build, licensees should be aware of the design of the assets and understand and manage the resulting implications and risks. Even if a licensee believes, having conducted a reasonable level of due diligence, that the design had been undertaken properly and to the level of reasonable skill and care expected, we do not consider it appropriate for the licensee to be able to defer the risks arising from defective work in the construction of the assets to others (including, ultimately, consumers). On the facts of the claim from BTLAL, we note no exceptional circumstances to alter this view.
- (d) We expect licensees to pursue third parties for remedies in respect of their negligent or below standard work and to put in place other commercial arrangements and risk management practices to ensure they can bear the consequences of such risks in the event there may not be any such recourse. We have seen evidence that the Licensee has pursued a commercial approach to resolving the matter and in doing so was able to recover a portion of the costs associated with the Event. The Licensee has therefore appropriately been able to manage the impact of the Event to some degree.
- (e) The bathymetric survey⁴ undertaken between 27 August 2013 and 9 September 2013 indicates that the scour had already started to occur at the time the Licensee took on the assets from the developer. We have noted that the timing of the Event coming to the Licensee's attention in December 2013 and the interaction of that timing with the grant of the Licence in September 2013 was unusual. However, in accordance with the principles set out above, the fact that the Licensee discovered the Event only after licence grant is not sufficient to

² Letter from the Licensee to Ofgem dated 18 September 2015

³ The framework for the Offshore regime also reflects this through the STC which deems the OFTO, for the purpose of the STC, to have been the party that developed the transmission assets from the point of asset transfer (paragraph 6.3 of Section G).

⁴ We note that the survey was commissioned by the developer of the wind farm as a result of obligations under the terms of the marine licence to conduct post construction bathymetric surveys.

demonstrate that the Event is an IAE and we do not consider the timing to be significant such that it might be an exceptional factor.

- (f) In summary, whilst the evidence we have seen does not suggest that the particular damage that occurred was reasonably foreseeable, there is nothing in the information provided that suggests to the Authority that the risk was of a type so unforeseeable or exceptional that a prudent licensee would not have contemplated that risk in assessing the project prior to submitting its tender or fixing the revenue entitlement. The Authority therefore considers that the Licensee is the most appropriate party to manage the risk of the Event and/or absorb the impact.

This determination also constitutes notice for the purposes of paragraph 23 of the Condition.

Dated: 27 October 2016

A handwritten signature in black ink that reads "S3 Beel". The signature is written in a cursive style with a large, stylized "S" and "3" followed by the name "Beel".

Stephen Beel
Partner, Commercial

Duly authorised by the Authority