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To interested parties

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Open Letter: Consultation on Income Adjusting Event policy in Offshore Transmission Licences

Introduction

This open letter commences a consultation on the income adjusting event (**IAE**) provisions in the offshore transmission licence (**the OFTO licence**). These provisions are set out in paragraphs 14 to 24 of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) (the **IAE Condition**) of the OFTO licence. We are concerned to ensure that the IAE Condition operates in the best interests of consumers in accordance with our principal statutory objective. We therefore are seeking views on whether or not the policy we have applied to the IAE Condition so far satisfies this objective; and, if not, on how the IAE policy could be strengthened, for both existing and future licensees, to ensure the risks are allocated in the most appropriate way to better protect the interests of consumers.

The purpose of this open letter is to commence the first stage of a consultation with interested parties. We currently consider that an amendment to the IAE policy is likely to be necessary, and we shall subsequently consult on any licence amendments required to implement that proposed policy. We are also considering in parallel whether there need to be other amendments to the wording of the IAE Condition, in particular whether it would be more appropriate to amend or remove paragraph 15(a) of the IAE Condition, which would be the subject of a subsequent consultation.

In this letter, we explain the IAE Condition, summarise the decisions we have made so far, and identify the policy concerns that have arisen, particularly in the context of cable failures caused by latent defects in the construction of offshore assets. We describe the interaction of the IAE Condition with developments in the insurance market for such risks. We then set out the approach we are considering in respect of the allocation of risk for latent defects for both existing and future licensees. We invite and encourage comments from all interested parties, and request responses to this open letter to be submitted on or before 6 March 2018.

The IAE Condition

The general purpose of the IAE Condition is to provide protection to OFTO licensees for identified unexpected costs arising from certain low probability but high impact events. Paragraph 15 of the IAE 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").'*

Events falling within limbs (a) or (b) are expressly defined and do not involve the exercise of the Authority's discretion in determining whether there is an IAE. An event falling within limb (c), however, does involve the exercise of our discretion, and as such requires the application of a policy to be set by reference to our statutory duties, in particular our principal objective to protect the interests of existing and future consumers in relation to electricity conveyed by distribution and transmission systems. If an event satisfies the definition of an IAE in limb (a), (b) or (c), such that the costs caused by the IAE are permitted to be 'passed through', the manner in which those costs are borne (in particular, how the costs are proportioned between the offshore generator and being socialised more widely) is determined by the terms of section 14 of the CUSC and not by the Authority.

How we have applied our discretion in limb (c) of the IAE Condition

Our first consideration of limb (c) for an OFTO licensee was in relation to a claim for an IAE made by Blue Transmission London Array Limited[1] in October 2016 (the **BTLAL Decision**). In assessing whether the event was an IAE under limb (c) in that instance, we developed a policy that considered whether or not the event was foreseeable, and whether the OFTO licensee was the most appropriate party to manage the risk of the event. This was consistent with our decisions in respect of IAE claims made by National Grid Electricity Transmission plc as the System Operator licensee in relation to the onshore licence. The policy set out in the BTLAL Decision consisted of the consideration of each of the following four factors:

1. whether the licensee knew of the event or circumstance before it arose or ought to have known of it;

2. 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);

[1] https://www.ofgem.gov.uk/publications-and-updates/publication-our-determination-relation-notice-income-adjusting-event-blue-transmission-london-array-limited

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3. 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; and

4. 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 have applied this policy in the subsequent three IAE claims we have received from OFTO licensees, as set out in the Thanet Decision[2] (May 2017), the GYM SSEC1 Decision[3] (May 2017) and the GYM SSEC2 Decision[4] (September 2017).

In the BTLAL Decision, which related to scour that had occurred where the four HV Export Cables cross a third party cable, we concluded that the type of risk that occurred was reasonably foreseeable and there were no exceptional circumstances to alter that view. We noted in that decision that the OFTO licensee had some recourse against third parties and was able to manage the impact of the risk to some degree.

Each of the Thanet Decision, GYM SSEC1 Decision and GYM SSEC2 Decision related to a fault in an export cable. In respect of the Thanet Decision, the OFTO licensee considered that the fault was a result of the interaction between the fibre optic cable and the power core. In respect of the GYM SSEC1 Decision and GYM SSEC2 Decision, the OFTO licensee considered that the fault had been caused by damage to the fibre optic cable and (in the case of the GYM SSEC1 Decision only) also the power core. In each of these decisions, we concluded that the type of risk that occurred was foreseeable and there were no exceptional circumstances to alter that conclusion on foreseeability. In the case of the Thanet Decision and the GYM SSEC1 Decision, we considered that the impact of such risks could be managed by a prudent OFTO licensee through commercial recourse and insurance arrangements.

In the case of the GYM SSEC2 Decision, the OFTO licensee submitted additional evidence to demonstrate that insurers would more likely than not have refused to cover the risk that eventuated of a subsequent cable defect. We therefore considered whether the OFTO licensee was the party best placed to manage such risk in accordance with the tests set out in the BTLAL Decision. On consideration of the evidence available, we concluded that it was more likely than not that the event had indeed become "*effectively uninsurable*" because insurance for the event would have been excluded or otherwise withdrawn. Overall, therefore, we found it to be an IAE. We concluded that the OFTO licence would provide protection under limb (c) of paragraph 15 of the IAE Condition for repair costs net of the sums recovered by the OFTO from commercial recourse against third parties. We also concluded that the IAE did not extend to a sum equivalent to the deductible that the OFTO would have had to pay had the event been covered by insurance.

Assessment of our existing IAE policy

In each of our IAE decisions, we have made clear that, similar to any other transaction involving a purchase of assets, an OFTO licensee should enter into the transaction of acquiring OFTO assets with the awareness that it is assuming any risks arising from damage or defects that it has not been able to discover through its due diligence. The

[2] https://www.ofgem.gov.uk/publications-and-updates/thanet-ofto-limited-determination-under-paragraph-23-amended-standard-condition-e12-j3
[3] https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-mor-ofto-plc-determination-under-paragraph-23-amended-standard-condition-e12-j3
[4] https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-mor-ofto-plc-determination-under-paragraph-23-amended-standard-condition-e12-j3-0

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offshore regime was not designed to insulate OFTO licensees from all such risks. We consider that latent defects are foreseeable types of risk, and OFTO licensees should put in place appropriate commercial arrangements to manage or absorb these risks.

Notwithstanding this, the GYM SSEC2 Decision allowed certain costs arising from a latent defect (net of amounts recovered through commercial recourse and a sum equivalent to the insurance deductible) to be passed through on the grounds that the risk had, on the balance of probabilities, become effectively or practicably uninsurable.

We wish to ensure that our existing policy appropriately allocates the risk of any uninsurable (or effectively uninsurable) latent defect, in order to ensure the right behaviours are incentivised from all parties and that pass through of costs is in the best interests of consumers.

There are some precedents in public private partnerships (**PPP**) projects for contracting authorities to provide protections – on a value for money basis – for certain risks that become uninsurable.[5] Such protections tend to be limited to those insurance policies in which the Authority is likely to have an interest from the point of view of maintaining continuity of service. They are based on a high bar for the definition of what constitutes uninsurability. HM Treasury guidance on PF2 contracts defines "uninsurable" as meaning, in relation to a risk, that (a) insurance is not available to the Contractor in respect of the Project in the worldwide insurance market with reputable insurers of good standing in respect of that risk; or (b) the insurance premium payable for insuring that risk is at such a level that the risk is not generally being insured against in the worldwide insurance market with reputable insurers of good standing by contractors in the United Kingdom.[6] The HM Treasury guidance on PF2 contracts also notes that "*under exceptional circumstances, it may not be value for money for the private sector to bear all the risks associated with placing an insurance programme itself (e.g. in the event of (i) non-availability of insurance or (ii) significant market-wide increases in insurance costs)".* It goes on to conclude in these cases, "*it is likely to be better value for money if an Authority provides a limited level of protection under specific circumstances"* for risks that become uninsurable. The guidance emphasises that, to ensure effective risk management by the private sector partner, such a private sector partner should remain liable for deductible related losses.

Our current IAE policy effectively provides a form of uninsurability protection for latent defect risks. However, we have not formally set out the definition of what constitutes uninsurability for the purposes of the IAE Condition. We would like to do so, and so are consulting on adopting a formal definition in the terms of the HM Treasury guidance for PF2 contracts, set out above. This would formalise the manner in which the IAE Condition would operate in the context of latent defect risks that become uninsurable.

The principal benefit of continuing to provide such uninsurability protection is that future OFTO licensees need not price the risk of uninsurable latent defects into their bids. It may not be good value for money, for instance, for all OFTO licensees to create contingent provisions to fund uninsurable cable failures caused by latent defects if the risk will crystallise only on a small proportion of projects. A secondary benefit of providing such protection is that it makes OFTO licensees – which are otherwise thinly capitalised entities – resilient to a series of such contingent failure events, and reduces the probability of a discontinuity in service provision.

[5] See e.g. HM Treasury guidance on *Standardisation of PF2 contracts*, Chapter 17 (Insurance): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207383/infrastructure_standardisation_of_contracts_051212.PDF

[6] Paragraph 17.9.3 of the HM Treasury guidance on *Standardisation of PF2 contracts.*

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However, providing protection for latent defect risks that become uninsurable creates some risks. In particular, it may weaken incentives on OFTO licensees to seek out – and insurers to continue to make available – insurance for latent defects, if licensees consider that risks not otherwise covered by insurance will be protected by the licence (at little or no cost to the licensee). By virtue of the licence providing 'insurance of last resort', it creates the risk of adverse selection, where insurers continue to cover "good" risks (where construction has been carried out to a high standard), leaving the "bad" risks (where it has not) to be passed through to generators and the consumer. We also have some concerns about the potential effect on licensees' incentives to conduct thorough due diligence if it is considered that insurance or the licence will always provide a safety net.

However, we consider that these risks can be properly managed by adopting a robust definition of uninsurability. We consider that a policy approach along the lines discussed above will have the practical effect that limb (c) of the IAE Condition will, apart from exceptional circumstances, never cover the first event of asset failure (on the basis that any such event would be properly insurable).

We also wish to ensure that the IAE Condition will not operate to provide 'windfall' benefits as compared to an insurance pay-out. We therefore consider it appropriate that the following safeguards should be built into the IAE policy / IAE Condition in the context of any claims on the grounds of uninsurability:

- *The Authority will apply a deductible to incentivise the OFTO to obtain and keep insurance wherever practicable and in line with HM Treasury guidance. We are considering a deductible of £5m or 30% of the claim, whichever is higher. We recognise that the impact of this deductible may differ depending on the specific project characteristics (e.g. size of the assets) and would be interested in hearing stakeholder views on how the deductible could be scaled to take account of this.*
- *Each IAE claim will be capped at the reinstatement value of the assets.*
- *Any claim will be paid net of all commercial avenues of recourse.*

The definition for 'uninsurability' would be set in accordance with PF2 (set out above) in order to encourage the OFTO to continue to approach the insurance market to insure the assets at regular intervals. As to the application of this definition in practice, we propose adopting a policy that (i) asks whether the definition would be satisfied by reference to an efficient OFTO with the particular features/characteristics of the OFTO (and its assets) that are the subject of the claim; and (ii) treats a pre-existing exclusion (apart from those existing at licence grant) on an insurance policy for a risk that has eventuated as being (in principle) able to satisfy the definition that insurance is not available in respect of that risk. If any licensee intends to claim that the definition of 'uninsurability' is satisfied in relation to an event it suffered, the licensee will bear the burden of proof of demonstrating this to the reasonable satisfaction of the Authority.

Proposed warranty/indemnity expectations and insurance requirements for future OFTO licensees

In addition to the above IAE policy, it is important to take account of the experience of cable failures caused by latent defects across the existing OFTO programme, and take action to ensure that incentives on the appropriate parties to avoid such failures are strengthened for future projects.

We consider that the offshore wind generator, as developer and user of the assets, should ultimately be responsible for the quality of the development of the assets. We therefore expect that for all future OFTO tenders, for TR5 and beyond, there will be

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sufficient contractual protections for the OFTO licensee to rely on for latent defects in the manufacture, supply and installation of the transmission assets. It should be noted that a large proportion of any IAE costs awarded will be passed through to the relevant offshore generator in any event, and so this remains a significant incentive to build fit for purpose assets.

We set out below the proposed ***minimum*** protections that we expect developers to offer to OFTO licensees, and expect that such protections will avoid the OFTO licensee pricing in significant contingencies into its annual tender revenue stream:

1. Five-year warranties (commencing at handover of completed assets to the developer) for all costs of repair and replacement of sub-sea cables procured by the offshore wind generator from its contractors, to have a cumulative minimum liability cap of 10% of the estimated transfer value of the transmission assets[7]; or

2. The offshore wind generator to provide contractual protection to the OFTO licensee to 'top up' the existing contractor warranties that will be transferred, in order to give the OFTO licensee an overall contractual protection that is equivalent to the above. This could either be done by the offshore wind generator:
   a) providing an indemnity backed by a rated security or parent company guarantee, or
   b) agreeing to retention by the OFTO licensee of 10% of the estimated transfer value for a period of 5 years (commencing at handover of completed assets to the developer).

In addition, we propose that all OFTO licensees should have – as a ***minimum*** – an Operational All Risk insurance policy with a LEG3 exclusion or equivalent which includes insurance protection for all cable repair costs.

Identification of issues for consultation

We are now in a process of consulting on our proposed way forward on the IAE Condition and the general approach to latent defect risk for both existing and future projects, as set out above.

Ofgem invites consultation responses on any aspect of the issues and proposals identified in this open letter, and specifically invites responses to the following three questions:

1. Do you agree with our assessment of the benefits and risks of the existing IAE policy, and the proposal to formalise and strengthen it as suggested above?
2. Do you consider that there are likely to be any other unintended consequences from implementing the proposed IAE policy as suggested above?
3. Is there anything else that Ofgem should take into consideration when deciding on the future policy for IAEs?

Next steps

Responses should be sent by **5pm on 6 March 2018** to Kate Kendall by email to offshorelicensing@ofgem.gov.uk

[7] To note, this option is likely to be more relevant to those projects that are sufficiently early in their procurement strategy.

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We are keen to engage with interested parties on the proposals set out in this open letter and, if likely to be helpful, will arrange discussions during the consultation period. If you would like to arrange a meeting, please email offshorelicensing@ofgem.gov.uk.

Once we have carefully considered all responses and other qualitative and quantitative analysis, we will publish a subsequent consultation on any licence changes we consider are required.

Yours sincerely,

Akshay Kaul
Partner, Competitive Networks

For and on behalf of the
Gas and Electricity Markets Authority

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