

Mr. Bjørn Harald Berge
Company Secretary
Dudgeon Offshore Wind Limited
1 Kingdom Street
London
W2 6BD

Direct Dial: 0203 263 9937
Email: Akshay.Kaul@ofgem.gov.uk

Date: 24 April 2017

Dear Bjorn,

Indicative Transfer Value for the Dudgeon project

Introduction

1. The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 (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 September 2016, confirming that the £377.2m forecast of costs provided to us on 5 July 2016, for the development and construction (including financing) of the Dudgeon 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 of the Project.

3. Statoil's Dudgeon project team (the Project Team) submitted a revised cost assessment template (CAT) on 17 February 2017, indicating a project cost of £353.0m. We have now completed the forensic review of the CAT and ancillary cost information provided by the Project Team. This letter sets out:

- an overview of the work that has been undertaken to estimate the ITV;
- our decision to set £310.9m as the ITV for the Dudgeon project; and
- the next steps in the cost assessment process.

Overview of work to arrive at the ITV

4. To inform our estimate of the ITV, we employed independent consultants Grant Thornton (GT). GT 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 March 2017.

5. Both GT and Ofgem encountered delays in obtaining the relevant information to estimate the economic and efficient costs for the Project. With the date of the Invitation To Tender (ITT) approaching, both parties agreed Ofgem would use the figures submitted in the CAT submission of 17 February 2017 as the basis for the value in the ITT, subject to the following adjustments:

- Contingency – as the project is now operational and the CAPEX is at an advanced stage, we have not included any contingency in the ITV. We have therefore removed the £4.1m contingency that was submitted;
- Cost updates – following discussions with the Project Team and further analysis, GT requested an update of costs. We have included these updates, which has removed £24.3m (including forex adjustments); and
- IDC – the last 3 months of IDC included in the cashflow submission has been removed, because the system was capable of transmitting from January 2017, and so does not attract IDC from that point onwards. Further adjustments have been made to the IDC, related to the above reductions and correcting the cashflow for the pre Financial Investment Decision (FID) spend. In total, there has been a reduction of £13.8m from the IDC submission.

6. There were some outstanding costs that GT had not been able to verify in the available time, such as variations and variation requests. GT have labelled these as "still under investigation". These will be reviewed at the FTV stage. Similarly, while GT have been able to substantiate most of the methodologies used to allocate costs to the OFTO assets, we have not been able to apply our full range of cost assessment tests to your submission in the time available. We will apply these tests at the FTV stage.

7. Please note that this approach does not mean that we consider the costs submitted are economic and efficient; nor does it mean that we have accepted the cost allocation methodologies. These will have to be reviewed and supported with evidence from the Project Team at the FTV stage.

Ofgem's decision on allocation and efficiency of costs

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

- the findings of the forensic review;
- the approach to allocating shared costs; and
- the IDC submission for the Project.

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

Findings of the forensic review

10. GT's review noted a number of cost increases and decreases from the initial submission of the revised CAT, which were discussed and accepted by the Project Team. Additionally, since the Project is near completion, we considered that there was contingency

which was no longer needed. The net impact of these movements is a reduction of £28.4m. The breakdown of this is included in appendix 1.

11. GT identified a further £33.8m of unsubstantiated costs. The Project Team has explained that these costs are estimates that may or may not be incurred and have only been able to provide partial justification for this amount. An aggregate summary of these costs is given in appendix 2.

Ofgem's position for the ITV

12. We have reduced the Project's ITV by £28.4m for the net effect of cost movements and the removal of contingency. In the interests of achieving the ITT timescales, we have agreed with the Project Team that the unsubstantiated costs still under investigation will be included in the ITV. Please note the Project Team will need to provide a robust justification if these unsubstantiated costs are to be considered for inclusion in the Project's FTV.

Allocation of shared costs

13. 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.

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

Ofgem's position for the ITV

15. We have undertaken a preliminary analysis of the information provided. We have noted the fact that the updated allocation rates still require detailed justification or further calculations to reflect the changes in estimated costs. In light of the limited time available, we have decided to include the original submission on pre-construction costs, and ongoing construction and development costs. We will undertake a more detailed review of the allocation rates in the process to setting the FTV.

Interest During Construction (IDC)

16. We reviewed the Project Team's IDC submission. We confirmed that the date of first power was in January 2017 and noted that IDC was being claimed for periods beyond when the system was capable of transmitting.

17. We informed the Project Team that the pre FID cashflow needed to be updated to reflect the actual CAPEX profile, as the entries in the CAT submission had been averaged over a 23 month period at the start of the project.

Ofgem's position for the ITV

18. We have removed the £6.6m from the IDC for the amounts included after first power. The Project Team have also submitted a revised cost template that has picked up the CAPEX adjustments arising from the GT review and corrected the pre FID cashflow. This has resulted in a further reduction to the IDC of £7.2m, giving a reduction of £13.8m in total. We note that unsubstantiated costs and any allocation adjustments may further affect the level of IDC at the FTV. The IDC value for the ITV after all of the current adjustments is £28.5m.

Indicative Transfer Value for the Project

19. The ITV for the Project is set out in Table 1 below.

Table 1: Comparison of February CAT submission and ITV

Item	February CAT submission (£m)	Indicative Transfer Value (£m)
Capital expenditure and development costs	310.7	282.4
IDC	42.3	28.5
Total	353.0	310.9

Next steps

20. 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 and development costs. This may be assisted by independent technical consultants.

21. If you have any questions regarding this letter, please contact Phill Heyden on 020 7901 0516 (or phillip.heyden@ofgem.gov.uk) in the first instance.

Yours sincerely,

Akshay Kaul
Partner, Networks

Appendix 1: Cost movement summary

Redacted

Appendix 2: Summary of costs “still under investigation”

Redacted