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02 March 2018

Ms Kate Kendall
Head of Commercial Delivery, Commercial
By email to: Kate Kendall at offshorelicensing@ofgem.gov.uk

Dear Kate

Consultation on Income Adjusting Event policy in Offshore Transmission Licences

Thank you for the opportunity to provide comments on this consultation. This response is provided by Balfour Beatty Investments (BBI) on behalf of the three OFTOs in which BBI has an interest: Gwynt-Y-Mor, Humber Gateway and Thanet. BBI has provided a general reaction to the consultation within the main body of this letter and a specific response to each consultation question at Annex 1.

Balfour Beatty (BB) welcomes Ofgem's consultation on the income adjusting event (IAE) terms in the offshore transmission (OFTO) licence. We consider that the overall direction taken by Ofgem is helpful because it:

- recognises that IAE claims are likely to occur for uninsurable latent defect faults beyond the OFTO's control ; and
- attempts to provide clarity on how the OFTO regime should apportion and price the risk exposure that it is exposed to.

However, we consider a 'belt and braces' approach has been applied by Ofgem's proposals that will cost the consumer more by creating further risks for OFTO investors, where a simpler approach may suffice. The proposed changes seek to require:

- Developers to provide additional construction guarantees, which is helpful since they are the appropriate party to bear responsibility for any latent defects; but it comes at a cost as developers will expect the additional obligations to be reflected in the Transfer Value;
- OFTOs to include latent defect insurance, which is a helpful obligation to mitigate the liability for all parties; but the proposal then penalises the OFTO if multiple latent defect failures occur with a common root cause that an OFTO can do little to avoid.
- The policy proposes a retrospective regulatory policy change which will apply to existing OFTOs as well as future ones; this potentially impacts existing risk allocations and financing arrangements.

In seeking the optimum regulatory solution to best benefit consumers, there is a balance between:

a) Developers providing an assurance package for the transfer of their assets,

b) the OFTO's providing an insurance package for transferred assets, and

c) Ofgem providing an IAE backstop in exceptional circumstances.

Considered as a whole, it makes sense that the larger the indemnity provided by developers, the lower the risk on Ofgem (and the OFTO) to cover additional costs that occur. It also follows that if an event occurs that is a legitimate IAE claim (particularly where the root cause was embedded prior to asset transfer) then exposing the OFTO to a share of the cost of any number of repeat failures of that root cause does not represent value for money for the consumer. The OFTO should certainly be encouraged to place insurance with latent defect protection for any number of independent latent defect failures, but to expose it to more risk than this is not compatible with the funding structure that generates the significant savings delivered by the OFTO regime.

Ofgem's current proposal places higher risk/cost on both developers and OFTO's. The proposal for an IAE deductible on OFTO's to incentivise appropriate behaviour makes no sense; if Ofgem is worried about appropriate insurance not being in place, it could simply impose an obligation on OFTO's to report annually on its compliance with the insurance requirements and to explain any gaps that exist.

The overall context

Ofgem has indicated that to meet its statutory duties it must ensure that IAE risks are allocated in the most appropriate way to protect consumer interests. This helps set the context in terms of:

a) the criteria for making their decisions; and

b) how Ofgem want to allocate the IAE risks in the most appropriate way.

The criteria for applying discretion under limb (c)

Ofgem's primary statutory duty is to protect the interests of existing and future consumers; in doing so they must consider a wide range of factors including decarbonisation and ensuring that licensees are able to finance their businesses. Ultimately the OFTO regime should ensure that offshore wind farms can deliver their clean energy to consumers as well as deliver the least cost and fit for purpose OFTO assets (https://www.ofgem.gov.uk/publications-and-updates/powers-and-duties-gema).

Ofgem is an active participant in the OFTO regime and must consider that investors in OFTOs and windfarms rely on Ofgem's transparent and consistent interpretation of its statutory duties. Ofgem has generated significant benefits for consumers through its comprehensive OFTO regulatory regime, and it will be important for Ofgem to recognise the potential negative impact a policy change may have on these benefits in future.

Any changes to the IAE condition must reflect the experience gained from past decisions but also be fit for purpose for the future. In the future, issues may include:

- Significant downward pressure on construction costs for offshore windfarms and offshore transmission that increases the likelihood of latent defects leading to cable failures.
- Future changes to latent defect insurance cover (from the current LEG3 definition)

- Commercial recourse for latent defects may change in the future or not be available
- Changing windfarm outputs or transmission requirements causing unexpected asset damage

In clarifying its IAE process under limb (c), Ofgem should add certainty and ensure consumers continue to benefit but also be able to take account of unforeseen future events that may occur.

What is the appropriate risk allocation?

So far offshore windfarm developers have built all the offshore transmission assets and this is unlikely to change. Following commissioning, the networks (and any undiscovered latent defect risk) have transferred to OFTOs. This latent defect risk has been accepted by OFTO investors and insurers in the expectation that Ofgem would provide the regulatory stability in its IAE determinations. Specifically, that it would treat legitimate events as a cost pass through in the event that an OFTO's commercial recourses (including appropriate insurance cover) failed to respond through no fault of the OFTO.

The generator-build OFTO regime allocates construction risk to the windfarm developer, who may in turn pass on this risk to its suppliers and contractors. The OFTO party then faces the challenge of taking over these assets based on whatever due diligence information is available, under pressure from a competitive tender process run by Ofgem. OFTO bidders only have a limited opportunity to undertake technical due diligence and must generally accept whatever warranty remains from the multiple construction contracts arranged by the developer. In any event, the commissioning records are often incomplete and the assets have not been operational for a long enough period to properly assess the latent defect risk. The tender rules make it virtually impossible for OFTO bidders to negotiate entirely sensible latent defect indemnities or assurances from the windfarm developer.

To use the example of the GyM OFTO cable failures, the best way of mitigating this failure was for the windfarm developer to undertake appropriate monitoring of the manufacturing and installation programme such that these defects would not have occurred. The wind farm developer could have mitigated this risk but did not. Instead, the risk was passed on to the OFTO without any material resources to manage it. This misallocation of risk is not in the interests of consumers overall.

We welcome Ofgem's attempts to pass the latent defect risk back to the party best placed to manage it (the developer), but we do not consider it has gone far enough. In particular, we note that Ofgem has drawn inspiration for its proposed changes from the PF2 guidance on uninsurability without recognising that in that regime, the '*OFTO*' party procures the construction work under a single contract with the benefit of a 12 year statutory limit on latent defect claims and an overall limit of liability of 50% (or more) of the overall construction cost. In contrast, Ofgem has proposed a 5 year limit on latent defect claims and an overall limit of 10% of the transfer value for any claims.

Setting an appropriate apportionment of risk

We welcome Ofgem's recognition that additional protection from the developer is required. However, the proposal that developers should offer 5 year warranties or equivalent protection is inadequate given the likely cost/risk of a cable replacement. Both the duration and value of the protection must be adequate to ensure repair.

If full cable replacements are required due to latent defects, these may be well in excess of 50% of the OFTO transfer value and the commercial rationale to take this action may not crystallise until some years after a latent defect arises. The decision-making process will be distorted if the Developer's indemnity expires within three or four years of Asset Transfer.

- OFTOs will require this indemnity to cover a longer period and be of sufficient value to cover the risk; Ofgem will want to ensure the OFTO remains fully incentivised to maintain and insure the transmission assets appropriately.
- Developers will want any protection it offers to be reflected appropriately in the Transfer Value; Ofgem will want to ensure generators procure and install cables properly, without including a significant risk contingency for potential latent defect costs that may never occur.

Any change to the IAE condition is clearly critical to developers and OFTOs. Ultimately the risk must be borne by one of the parties and this should be the party best able to manage the impact.

BB considers that a more cost effective solution would be to:

a) Require OFTOs to demonstrate that they have followed Good Industry Practice to operate, maintain and insure the transmission assets;

b) Cap the OFTO's exposure to a set of latent defect failures with a common root cause, providing that each failure that occurs in the set has (or was most likely to have) a similar root cause dating before the asset transfer date and the OFTO could not have taken any action to avoid its occurrence (without incurring a cost comparable to the cost of rectifying the occurrence); the cap for each unique latent defect set of failures should be a fixed amount in aggregate irrespective of the number of failures making up the set;

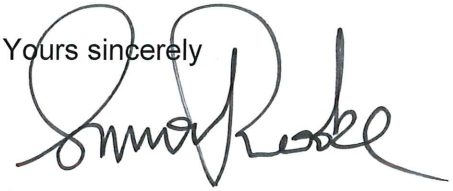
c) Pass on any costs in excess of this cap to the Developer;

d) Allow the Developer to determine the most cost effective way of managing its exposure, which may include specifying the reasonable obligations that the OFTO should undertake following asset transfer;

e) The OFTO should be obliged to maintain insurance cover at a level equivalent to insurance cover with a LEG3 exclusion and to provide an independent annual report confirming that either (i) this level of insurance cover has been placed, or (ii) confirming that the next best available insurance cover has been placed and the reasons for the gap in insurance cover.

We trust that Ofgem find these responses useful in informing the proposed changes. Please do not hesitate to contact me if you wish to discuss any of the items raised in this letter.

Yours sincerely



Simon Rooke
Investment Director
On behalf of Balfour Beatty Investments

Enc Annex 1 - Response to specific questions

Annex1
Responses to specific consultation 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?

Assessment of the benefits and risks of the existing IAE policy:

In responding to this question we have quoted specific elements of the consultation document and provided our reaction to them.

1. "*The offshore regime was not designed to insulate OFTO licensees from all such risks [arising from damage or defects that it has not been able to discover through its due diligence]*" (pg 3, para 4):
    a) Contrary to the above, our understanding was that the EE and IAE protections were indeed there to protect against the impact of risks that the OFTO could not have foreseen through appropriate due diligence. This was to ensure that an OFTO could secure project finance at a high gearing and deliver the savings that have actually been delivered by the OFTO regime. Senior funders to this asset class have relied on this understanding in setting the very attractive terms that consumers have benefitted from.
    b) Ofgem has determined a number of EE claims that has confirmed the market's expectation of how that protection was expected to work. The principle here is that an OFTO should secure revenue protection if events occur that it could not have been responsible for or could not have avoided. The same principle had expected to apply in the context of IAE claims.
    c) Furthermore, the IAE condition expressly permitted the OFTO to claim the entire sum that qualified as an IAE thereby effectively capping the OFTO's liability for any specific latent defect to the value of one deductible; the OFTO could then take a risk based on the level of deductible that it was prepared to accept.
    d) On this basis the offshore regime was, in fact, designed to insulate OFTO licensees from damage or defects <u>that a reasonable party could not have discovered through its due diligence</u> [emphasis added].
    e) The proposed changes in the open letter suggests that Ofgem has not fully appreciated the reliance that the OFTO market took from the IAE mechanism or it is seeking to fundamentally and retrospectively change the IAE mechanism rather than simply clarifying points of interpretation.
2. "*latent defects are foreseeable types of risk*" (page 3, para 4):
    a) Whilst it is reasonable to assume that latent defects may arise, it does not represent good value for consumers for an OFTO entity to include a contingency for them. The normal strategy is to expect to pass the risk on to the party that created the latent defect or, <u>after sufficient time has elapsed</u>, to rely on insurance;
    b) The way that OFTO assets are procured has typically meant that the OFTO cannot rely on a sufficient time period to pass, on the latent defect risk, before taking ownership of the assets; furthermore the multiple contracts approach means that it can generally

only recover a portion of the cost impact. This was recognised in the early stages of the OFTO regime and addressed by the Licence protections for exceptional events and income adjusting events;

c) The OFTO certainly should not be expected to foresee or make provision for a latent defect to arise that results in multiple repetitions, especially in the offshore export cables where the cost of repairs are significant.

3. "*continuing to provide such uninsurability protection is that future OFTO licensees need not price the risk of uninsurable latent defects into their bids*" (page 4, para 3)

a) The proposed provisions mean that the OFTO may be exposed to an unlimited number of deductibles for a repeatable latent defect that it could not have foreseen. The OFTO's funding structure is not designed to accept such a position and it is not reasonable, efficient or economic for the OFTO party to attempt to calculate the contingency to allow for this risk, which may never be realised.

b) In the context of the current drafting of the IAE Licence Condition, the proposed change effectively makes the OFTO less resilient to a series of such contingent failure events.

c) Ofgem has proposed to apply a deductible that is set at the maximum of £5m or 30% of the IAE claim. Insurers fix deductible levels by reference to fixed amounts (or a fixed number of revenue days) regardless of the claim; they never apply a deductible that is variable in the manner that Ofgem is currently proposing. There is no legitimate basis for applying a variable deductible.

d) The application of a deductible is a fundamental and unwarranted change to the IAE condition that has the effect of changing the protection from all legitimate costs where the total exceeds £1m to a best case of only allowing legitimate costs in excess of £5m.

e) Insurers typically cover OFTOs up to the Estimated Maximum Loss (EML) which is generally significantly less than the Reinstatement Value; if there really was a cost exposure in excess of the EML limit of the insurance policy then this would potentially be the subject of a separate IAE claim.

f) Ofgem does not address the issue of liquidity for managing the size of claims that it envisages in its open letter. Insurance policies typically include a provision that insurers will use their discretion in determining whether to provide the insured party with liquidity to manage the repair or reinstatement cost. This typically means that for claims associated with cable repairs, insurers may not provide interim payments; for claims associated with a total loss where the repair or reinstatement occurs over a longer period, then the insurer is likely to provide interim payments to cash flow the work. It would be helpful if Ofgem could set out how this element would be managed if such an event followed the IAE route.

4. "*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*" (page 4, para 4)

a) The logic for this consideration is ill-founded. Insurers consider that the market has not responded quickly enough to address the issues that have caused the sort of cable failures that have occurred on OFTOs. The market, in this context, includes the generators, cable manufacturers and installers. Insurers consider that these entities

should have already acted to avoid the repetition of these sorts of avoidable issues and consider that their actions to apply endorsements or exclusions is perfectly reasonable – irrespective of the proposals that Ofgem has set out. Fundamentally, insurers consider that once latent defects materialise they become known factors rather than fortuities and are therefore not insurable events.

b) OFTO entities are improving their due diligence techniques prior to transfer but they can never be in a position to properly investigate a particular asset's propensity to suffer latent defects by virtue of (i) the inaccessibility of certain parts; (ii) the fact that the OFTO entity was not present during the construction phase; (iii) the complications that arise by virtue of the developer having delivered the construction phase through multiple contracts, and (iv) the fact that the assets have not been operating for any reasonable period of time.

5. "*adopting a robust definition of uninsurability*" (page 4, para 5):

a) We agree that it would be helpful to formalise this for future clarity and accept that the PF2 definition is a useful starting point providing that proper cognisance is taken of the different circumstances that apply by virtue of the offshore element of the OFTO assets.

b) PF2 projects are generally DBFO style projects managed by a special purpose vehicle that covers all phases of the project and therefore this entity can more readily manage the latent defect risk across those phases, whereas the OFTO party has no real control over the construction contract, which in any event is further complicated by being multiple contracts with no overarching wrap.

c) The [PF2] SPV typically procures a single construction contract and can rely on the statutory right to a 12 year limit on claiming for latent defects that arise, whereas Ofgem has suggested five years.

d) The construction contract used in the PF2 regime typically imposes a limit of liability in excess of 50% of the construction value, whereas Ofgem has proposed 10%.

e) The uninsurability issue on PF2 projects is principally related to there being no insurance cover available rather than a specific endorsement of cover being applied – this is because specific endorsements are rare in PF2 or PFI projects – largely because of the benefit of the 12 year latent defect protection.

Proposal to formalise and strengthen:

1. We note that Ofgem intends to conduct a separate consultation on the deletion or amendment of limb (a) to the IAE Condition and we look forward to responding to that consultation. We understand and accept the four factors that Ofgem considers in applying its discretion under limb (c) of the IAE Condition.

2. Ofgem has proposed that five-year warranties (commencing at handover of completed assets to the generator) 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:

a) We do not consider that five years is sufficient for a latent defect to have fully developed – compare with 12 year statutory liability for latent defects in typical PF2 or PFI contracts;

b) We recommend that construction supply and install contracts generally should be signed as a Deed under English Law as this would add further strength to the ability to raise damages claims for latent defects for up to 12 years after takeover and that any intermediate warranty provision should not act to remove that right;

c) We consider that a cap set at 10% of the Transfer Value is insufficient for dealing with multiple failures in the offshore cable. It would be more appropriate to set a general liability cap of 10% of the Transfer Value for issues other than the offshore export cable and a specific liability cap for offshore cable latent defects set at 100% of the value of the offshore cable supply and installation contracts;

d) The Generator should also be prepared to extend its indemnity beyond the warranty period if more than one event of the same root cause occurs within the warranty period. This would more effectively address the objective of making the offshore wind generator ultimately responsible for the quality of the development of the assets.

3. The general principle (from PF2) setting out the circumstances that explain how uninsurability has arisen and continues to exist is reasonable, however:

a) it is prepared in the context of onshore assets where the deductibles are far lower in proportion to the asset value;

b) the construction contracts (in PF2 and PFI) are far more robust (i.e. single rather than multiple contracts) that ensure the full cost of repairing latent defects can be claimed;

c) there is an established principle of pursing the construction contractor for latent defects that occur up to 12 years from handover (not five years as Ofgem propose).

d) In a situation where there is a specific latent defect identified pre transfer then insurers are likely to immediately apply an exclusion. If there is a cable warranty for five years as Ofgem proposes but the specific latent defect does not materialise during this time, it does not necessarily follow that insurers would remove the exclusion. If the specific latent defect then materialised after the end of the five year warranty period, the OFTO would be facing the first repair with no insurance. The uninsurability definition should not disqualify this scenario by virtue of the fact that it is the first event to affect the OFTO.

4. "*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.*" (page 5, para 4):

a) This objective is not achieved with the current proposal because if a latent defect does occur after, or extends beyond, the proposed five year warranty period then the OFTO bears a significant burden that it cannot effectively manage or effectively quantify at bid stage;

- If the OFTO includes a risk allowance that is ultimately not required then it earns a windfall bonus that does not represent good value for money for the consumer;
- If the OFTO does not include a risk allowance that ultimately is required then it is highly likely to create the circumstances for implementing the OFTO of last resort;

In any event the burden is not being borne by the generator.

5. Application of a deductible:

   a) Whilst it is accepted that an OFTO is required to take the risk that there may be a number of latent defect failures that occur with different root causes and that it should evidence that it has placed insurance with latent defect cover, it does not agree that it represents value for money to require it to price for any number of latent defect failures with the same root cause.

   b) The proposal to impose a deductible that cannot be defined is a very material retrospective change to the original intent particularly in the context that an IAE claim is only likely to occur if insurance has failed to respond.

2. Do you consider that there are likely to be any other unintended consequences from implementing the proposed IAE policy as suggested above?

1. The approach to apply a deductible concept for an unlimited repeat of the same root cause creates an uncapped liability that will not be efficient to price and therefore is not in the interests of the consumer.
2. This may result in less competitive financing terms for all OFTOs even though the issue it is seeking to address may only affect a few. This approach does not serve the consumer's interests effectively and is likely to represent poor value for money.
3. If specific latent defects can be identified at the outset, or if the context of a particular situation is similar to a known latent defect issue in another context, then more specific protection should be offered to the OFTO. For example, if the design or manufacturing features of an offshore cable have led to more than one offshore cable failure on an operational OFTO and the same features exist in the offshore cable for a proposed OFTO, then the OFTO should be insulated from losses provided its actions do not directly lead to or accelerate the specific failure event.
4. The proposal fails to properly encourage the developer to actively address the issues that give rise to the occurrence of latent defects that result in insurance exclusions (and ultimately IAE claims) and passes on a burden to a party that is least able to manage the impact.

3. Is there anything else that Ofgem should take into consideration when deciding on the future policy for IAEs?

1. BB considers that a more cost effective solution would be to:

   a) Require OFTOs to demonstrate that they have followed Good Industry Practice to operate, maintain and insure the transmission assets.

   b) Cap the OFTO's exposure to set of latent defect failures with a common root cause, providing that each failure that occurs in the set has (or was most likely to have) a similar root cause dating before the asset transfer date and the OFTO could not have taken any action to avoid its occurrence (without incurring a cost comparable to the cost of rectifying the occurrence); the cap for each unique latent defect set of failures should be a fixed amount in aggregate irrespective of the number of failures making up the set.

c) Pass on any costs in excess of this cap to the Developer.

d) Allow the Developer to determine the most cost effective way of managing its exposure, which may include specifying the reasonable obligations that the OFTO should undertake following asset transfer.

e) The OFTO should be obliged to maintain insurance cover at a level equivalent to insurance cover with a LEG3 exclusion and to provide an independent annual report confirming that either (i) this level of insurance cover has been placed, or (ii) confirming that the next best available insurance cover has been placed and the reasons for the gap in insurance cover.

2. Ofgem has not explained how the open letter proposals will apply to OFTO's procured in OFTO rounds prior to TR5. As it stands, the policy proposes a retrospective regulatory policy change which will apply to existing OFTOs as well as future ones, even though the existing projects do not have the additional proposed developer protections. This potentially impacts existing risk allocations and financing arrangements on those OFTOs.

3. Ofgem has not explained how the IAE mechanism would deal with the issue of cash flow in responding to large claims that satisfy the proposed circumstances of uninsurability – currently IAE claims can only be raised after legitimate expenses have been incurred, but OFTOs are unlikely to have the resources to cash flow very large repairs that would be legitimate IAE claims. To build in sufficient cash flow capability would not be efficient.

4. In some situations a potential risk of a specific latent defect may be known before asset transfer i.e. it is foreseeable and definable, but the likelihood of its occurrence cannot be determined. In these situations, it generally does not represent value for money for the OFTO to attempt to price for such a risk. Furthermore, following the implications of Ofgem's objective (of making the offshore wind generator ultimately responsible for the quality of the assets) implies that this risk should be retained by the generator or, at least, the OFTO should benefit from specific contingent event protection if the latent defect materialised.