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Our Reference DTC180517-1

## **OFTO Tender Process – Consultation for Future Tender Rounds**

### **Confidential response due to commercially sensitive information**

Dear Kate,

We would like to thank you for providing us with the opportunity to respond to your consultation on the OFTO tender process for future tender rounds.

We, Diamond Transmission Corporation Limited ("**DTC**"), a wholly owned subsidiary of Mitsubishi Corporation ("**MC**"), would like to respond to the captioned consultation based on our experience of investing in and operating offshore transmission assets (OFTOs) in Great Britain.

At this moment, we own five OFTOs in the UK (Walney 1, Walney 2, Sheringham Shoal, London Array and Burbo Bank Extension) via Blue Transmission Investments Limited and Diamond Transmission Partners BBE Limited.

Please refer to Appendix A to this letter for our response to the above consultation.

In summary we consider the current OFTO tender process works effectively and has led to a pool of robust, financially and operationally secure OFTOs. We therefore consider a more evolutionary change is required in order to meet the new objective of 'Undertake streamlined and efficient tender processes'. This would take the form of:

- rationalising the EPQ process, see our response to question 3c;
- removing the duplication of questions between the EPQ and the ITT and within the ITT, see our response to question 4c; and
- assessing the robustness of the technical capability of bidders over the 20 year project life, see our response to question 4d.

We consider both the moderate and significant change proposals will lead to a less robust TRS, less operationally robust SPV, and is unlikely to deliver a lower TRS.

In the moderate change proposal the move to a threshold will reduce the robustness of bidders, as once a threshold has been made the focus will be on price, to the detriment of robustness e.g. there would be no incentive to seek committed bank finance terms for a 12 month period over an uncommitted public bond solution.

We do not consider the significant change proposal to be viable. Our rationale for this position is demonstrated in our response to questions 5b to 5f.

Under both proposals not limiting the number of bidders to go through to the ITT stage may initially increase the number of bidders but the OFTO market can only sustain so many bidders given the costs, time and effort to tender and the limited project pipeline.

Therefore we consider any increase in the number of bidders will be temporary and either new entrants or existing bidders will eventually withdraw from the market leaving the OFTO process less robust. We also consider that an unlimited number of OFTO bidders could, in the short term, be detrimental to price, as there are only a limited number of O&M service providers, insurers, competent advisors and funders in the OFTO market. Having unlimited bidders approaching all these parties could result in more generic pricing with a lack of willingness to engage with individual tenderers to generate innovation.

Overall we are concerned that the focus of both the moderate and significant change proposal is overly focused on attracting new entrants, with the view that new entrants will drive better value for the consumer. Our understanding is that throughout the OFTO tender process new entrants have been shortlisted and invited to submit ITT responses, but that they have not submitted a tender e.g. USS and National Grid TR2, John Laing Investments TR2 Group 2 and Triton Transmission (Dalmore/DIF consortium) TR5. It is interesting to note that the majority of these new entrants have been infrastructure investors/funds. We consider that the detailed questions in the ITT have helped these bidders understand better the risks they will need to manage and the differences between the complexity of the OFTO asset class and the more standard PPP/PFI projects they are used to. We do not consider their failure to bid to be a result of the onerous ITT requirements but rather a fuller understanding of the complexity of, and the risks surrounding, the assets they will be required to manage.

If you have any follow up queries, or would like a meeting to discuss our response, please do not hesitate to contact me on 07785 527154 or at [gary.thornton@diamondtransmissioncorp.com](mailto:gary.thornton@diamondtransmissioncorp.com).

Regards,



**Gary Thornton** B Eng(Hons), C Eng, FIET

**Technical Director – Diamond Transmission Corporation**

## **Appendix 1 – Response to OFTO Tender Process – Consultation for Future Tender Rounds**

### **1. Have we identified (in Chapter 1) the right drivers for possible change to the OFTO tender process? Are there other drivers for change we should consider?**

#### **Response:**

We concur that the OFTO market is now a mature market and consider the main driver for the OFTO tender process review is that projects are becoming larger with a step change in distance from shore and asset value. It has been several years since the last major review of the OFTO tender process and as such a review is overdue enabling lessons from other infrastructure tenders to be considered, although there is little detail on what these lessons might be in the consultation.

We consider that the current tender process has delivered:

- robust transmission services, resulting in a high degree of availability; and
- certainty and best value to the consumer through a competitive process.

The OFTO market is mature and can only sustain so many bidders given the costs, time and effort to tender and the limited project pipeline. Whilst attracting new entrants is important to any sector it is equally important that any new entrants are able to demonstrate that their technical and financial capability is comparable to existing players, particularly at a time when the projects being tendered are increasing in both size and complexity.

Given the design and licence protections we do not consider the recent contractor insolvency issues is a driver for change.

One additional driver for change which should be considered is the operational issues encountered by OFTOs now the market has been in place for several years. The capability of the OFTO in dealing with technically and financially complex low probability high impact events can have a major impact on the OFTOs availability. As such this aspect should be taken into account in any revised OFTO tender process. Costs to consumer are not restricted to tender revenue stream but also lost generation over the lifetime of the project. Currently the tender process is only focused on robustness of price.

### **2: Are the objectives of our review appropriate? Are there any other objectives that we should consider?**

#### **Response:**

We have no comments on the objectives of the review and consider them appropriate.

### **3: With respect to the existing tender process arrangements:**

- a) Are any different or additional arrangements needed to mitigate the risk of OFTOs not being financially or operationally robust?**
- b) In particular, do you consider that our tender process would be robust to a Carillion-type scenario? Are there additional questions we should ask at EPQ or ITT?**
- c) Do you have any other specific feedback on the existing tender process?**

**3 a) Response:**

The current process which includes detailed financial reviews by lenders and ratings agencies provides robust financial and operational OFTOs.

Lenders and rating agencies continue to monitor the financial and operational strength of the OFTO during the course of the project. This includes any change to ownership and O&M service provider, all of which normally require lender approval.

The one area that could be improved is scoring how bidders will deal with unforeseen events and the technical capability of bidders in operating technically complex assets to maximize availability and minimize and outage time.

**3 b) Response:**

We consider the current tender process to be robust to a Carillion type scenario due to:

- no construction risk;
- a choice albeit not extensive range of O&M service providers, with as a last resort the developer being able to provide O&M services;
- other than control room monitoring, of which there is a small selection of operators, the planned maintenance of OFTO assets is not a daily occurrence and the insolvency of an O&M supplier should be manageable through short-term contracts with alternative specialist providers until a competition has been run to select a new long term O&M provider;
- for wet services (i.e. offshore services) we operate a call-off contract under a framework agreement meaning that the insolvency of any individual such sub-contractor would not impact our service delivery;
- financial ring fencing of each OFTO project as dictated by the transmission licence; and
- transmission licence protections.

**3 c) Response:**

The OFTO market can only sustain so many bidders, due to technically complex assets, bid costs, time and effort required to bid and limited project pipeline, regardless of which tender process is developed for future OFTO rounds.

The current OFTO tender process is costly and labour intensive. Even at the EPQ stage significant time and effort is required to ensure the EPQ is at the right standard as demonstrated in TR5 EPQ2 where only three bidders were shortlisted.

We consider an improvement to the current process would be for an EPQ should cover all projects in any one tender round and dependent upon timing, potentially more than one tender round e.g. we do not consider it was efficient to split TR5 into two EPQ groups, and undertake three EPQs within a 12 month period (TR4, TR5 Group 1 and TR5 Group 2).

Our understanding is that Ofgem only evaluates the robustness of the tenders in terms of risk of price movement from ITT submission to financial close and does not take into account operational robustness post financial close. Pricing of unknown risks is a major concern in the current process as any additional costs priced into the bid increases the TRS resulting in a less competitive bid even if these costs will increase the availability over the life time of the project and hence reduce lost generation costs to the consumer. Examples are:

1. Cable spares: adequate cable spares (onshore or offshore) are essential in order

to limit the outage and cost of lost generation in the event of a cable failure due to long lead times which can be up to 18 months. If the developer does not provide adequate cable spares as part of the FTV then a responsible bidder will need to add costs to purchase spares as part of its bid.

2. Incomplete seabed burial or mobility data resulting in unknown risks for bidders.

We consider in instances such as the two examples above, Ofgem should provide direction as to what should be applied by each bidder in order to provide a level playing field and/or provide a scoring mechanism which means in the example 1 above the responsible bidder gains a higher robustness score, rather than being penalised by having a higher price, due to being a responsible asset manager/owner. At present it is hard to see how this is taken into account under the current scoring mechanism where only 20% of the robustness score relates to operational elements and even then this 20% only relates to firmness of price.

#### **4: With respect to the moderate change package:**

- a) **Do you believe this option would be an improvement over the current tender process?**
- b) **Do you agree with our assessment of this package against the objectives?**
- c) **Do you consider that there are questions that could be removed from the ITT questionnaire (for example, where there is overlap with the EPQ, or where the approach is mandated elsewhere)? For what reason and benefit could they be removed?**
- d) **Are there any amendments to this package that would improve it?**
- e) **What are your views on the most appropriate ways to mitigate the challenges of this package?**
- f) **Are there other considerations we should have taken into account that present practical or other challenges to implementation?**
- g) **Where we were to allow conditionality only on particular elements of a bid, how should we take into account conditionality in bids which cumulatively raises concern about the overall robustness of the bid?**

**Where possible, please quantify or describe qualitatively any benefits or burdens from this package of change.**

#### **4 a) Response:**

Whilst improvements to the current system could be enacted we consider the proposals as presented in the moderate change package would be detrimental to the OFTO tender process.

The move to a threshold will reduce the robustness of bidders, as once a threshold has been made the focus will be on price, to the detriment of robustness e.g. there would be no incentive to seek committed bank finance terms for a 12 month period over an uncommitted public bond solution.

Removing the number of bidders to go through to the ITT stage may initially increase the number of bidders but the OFTO market can only sustain so many bidders given the costs to tender and the project pipeline. Therefore we consider any increase in the number of bidders will be temporary and either new entrants or existing bidders will

eventually withdraw from the market leaving the OFTO process less robust.

We also consider that an unlimited number of OFTO bidders could, in the short term, be detrimental to price, as there are only a limited number of O&M service providers, insurers, competent advisors and funders in the OFTO market. Having unlimited bidders approaching all these parties could result in more generic pricing with a lack of willingness to engage with individual tenderers to generate innovation.

**4 b) Response:**

We consider the moderate proposal as presented will have a negative overall impact against the OFTO regime objectives.

Altering the robustness score of 40% to a threshold level will have little impact on the time and cost of the process, as bidders will need to answer the same questions and ensure they meet and exceed the minimum threshold. We therefore consider this aspect to be neutral from a bidder's perspective. It may however reduce the robustness of the bids leading to an overall negative against the objectives; certainty of price does not work with a less robust tender process.

100% weighting on price without a commensurate robustness score will increase the risk of an OFTO not being financially sound, although there are checks and balances via lenders and credit rating agencies. We also consider that a 100% weighting on price could incentivise "gaming" from bidders to ensure they win on price and then seek to re-open the price at PB stage, which there could be more scope to do if the robustness threshold has been achieved e.g. a more extensive Confirmatory Due Diligence list containing more issues by which costs could be changed.

Also as mentioned in our response to 4 a) we consider that an unlimited number of bidders could be detrimental to price due to the limited number of O&M providers, insurers, competent advisors and funders in the OFTO market. Having unlimited bidders approaching all these parties could result in more generic pricing with a lack of willingness to engage with individual tenderers to generate innovation. We therefore consider this to be a negative.

In attracting new entrants and not limiting the number of ITT bidders, the higher number of bidders means a higher bid cost to win ratio increasing TRS to the detriment of the consumer. This results in a less streamlined and efficient process.

Overall we believe the moderate change proposal will lead to a less robust TRS, less operationally robust SPV, and is unlikely to deliver a lower TRS. The process may initially attract new entrants but the OFTO market can only sustain so many bidders given the costs, time and effort to tender and the limited project pipeline. Therefore we consider any increase in the number of bidders will be temporary and either new entrants or existing bidders will eventually withdraw from the market and the OFTO process will be less robust.

**4 c) Response:**

We believe there are several areas where duplication could be removed or streamlined between the EPQ and the ITT being:

- the EPQ section for 'Approach to Asset Takeover' could be expanded to include the questions in the ITT 'Asset Takeover' not covered in the EPQ and thus the ITT question 3 removed.
- the EPQ section for 'Approach to Management and Operations' could be expanded to include the questions in the ITT 'Asset Takeover' not covered in the EPQ and thus the ITT question 4 removed. This would also reduce or remove EPQ Section



8 as risk management is included within the existing ITT Section 4.

- the duplication between the EPQ Question 6f (decommissioning) and the ITT Section 5 could be removed from the ITT.
- as the finance solution is very project specific the benefit of asking the detailed funding solution in the EPQ Section 7 especially for experienced bidders is of little benefit in a mature market. In addition the EPQ already requests bidders to demonstrate their funding experience by providing a response to the EPQ question 3A.

The scores from the EPQ could be carried forward into the ITT stage of the process to take account of the removal of ITT Sections 3, 4 and 5. Robustness will still need to be demonstrated in Section 8 of the ITT. To support this Section 1 of the ITT is confirmation of the EPQ submission.

With regards to further streamlining of the ITT we suggest the following:

- As the finance deliverability and robustness is assessed in ITT Section 8 and as such duplicates a lot of ITT Section 6 we consider the value of ITT Section 6 is limited and as such can be removed, with any questions that are considered necessary being incorporated in Section 8Ah of the ITT.

In summary we consider sections 3-6 of the ITT can be incorporated into the EPQ or section 8 of the ITT.

#### **4 d) Response:**

Expanded robustness scores with operational and technical capability should be taken into account in the scoring which at present is only robustness of price up to asset transfer. To ensure the continued high availability rate of OFTOs bidders should provide a proven track record of being able to prevent and manage faults, for new entrants this may need the input of specialist service providers.

Pricing of unknown risks is a major concern in the current process as any additional costs priced into the bid increases the TRS resulting in a less competitive bid even if these costs will increase the availability over the life time of the project and hence reduce lost generation costs to the consumer. Examples are:

1. cable spares: adequate cable spares (onshore or offshore) are essential in order to limit the outage and cost of lost generation in the event of a cable failure due to long lead times which can be up to 18 months. If the developer does not provide adequate cable spares as part of the FTV then a responsible bidder will need to add costs to purchase spares as part of its bid.
2. incomplete seabed burial or mobility data resulting in unknown risks for bidders.

We consider in instances such as the two examples above, Ofgem should provide direction as to what should be applied by each bidder in order to provide a level playing field and/or provide a scoring mechanism which means the responsible bidder gains a higher robustness score, rather than being penalised by having a higher price. At present it is hard to see how this is taken into account under the current scoring mechanism where only 20% of the robustness score relates to O&M and even then this 20% only relates to firmness of price up to financial close.

#### **4 e) Response:**

Refer to answers to 4b to 4c above.

**4 f) Response:**

Apart from the market only being able to sustain a certain number of bidders, the supply chain is also a limiting factor. We have already seen 'fatigue' in the insurance market with a limited number of insurers some of which are concerned on pricing the current number of bidders for each OFTO and some becoming exclusive to one bidder. The more bidders at the ITT stage then the more acute the issues of the supply chain will become with only a limited number of insurance providers, O&M service providers, insurance brokers, and technical advisors etc. in the market. This could lead to generic pricing removing innovation to the detriment of the consumer. It should also be noted even organisations that can run 'trees' have a limited capacity in this regard.

**4 g) Response:**

Conditionality within the bids should only be allowed where there is uncertainty with regard to an issue due to the data presented in the data room at the ITT stage. In such cases Ofgem should provide direction as to what should be applied by each bidder in order to provide a level playing field.

**5: With respect to the significant change package:**

- a) Do you believe this option would be an improvement over the current tender process?
- b) Do you agree with our assessment of this package against the objectives?
- c) Are there any amendments to this package that would improve it?
- d) What are your views on the most appropriate ways to mitigate the challenges of this package?
- e) Are there other considerations we should have taken into account that present practical or other challenges to implementation?
- f) What do you think of potential bid bond arrangements, pain/gain share mechanism and consequential changes to allow efficient unconditional bids?

**Where possible, please quantify or describe qualitatively any benefits or burdens from this package of change.**

**5 a) Response:**

We do not consider the proposed significant change options are an improvement over the current system that has produced robust financially and technically stable OFTOs. Our rationale for this position is demonstrated in our response to question 5b to 5f.

**5 b) Response:**

We agree with the impact of 'XX' for the objective 'Deliver transmission infrastructure to connect offshore generation, on a timely basis, and ensuring that OFTOs are robust and can deliver transmission services successfully over the licence period'.

We do not consider the changes proposals are neutral with respect to providing certainty and best value to consumers and as such should be a negative position. We consider more bidders could have the impact of increasing price given the limited suppliers in the market and without robustness evaluation there will be a high degree of uncertainty whether the arrangements could be put in place or are sustainable. The impact could therefore increase costs to the consumer and also result in additional lost availability



over the life time of the project thus increasing the costs of lost generation to the consumer.

Whilst the proposals may initially attract new entrants to the market this will be a short term impact as the OFTO market can only sustain so many bidders, due to technically complex assets, bid costs and project pipeline, hence the score should be neutral. Therefore is a significant risk that more robust experienced bidders maybe lost to the market.

Please refer to our response to question 5e on why we consider the proposed streamlined process will not work in practice and hence why we consider the objective should be negative.

**5 c) Response:**

We strongly consider there are too many issues and risks with the significant change package, as described in our response to question 5e demonstrates to make it a viable option.

**5 d) Response:**

Please see our responses to question 5c and 5e. The current tender process has led to a pool of robust, financially and operationally secure OFTOs. We therefore consider a more evolutionary change is required in order to meet the new objective of 'Undertake streamlined and efficient tender processes'.

This would take the form of:

1. rationalising the EPQ process (see our response to question 3c);
2. removing the duplication of questions between the EPQ and the ITT and within the ITT (see our response to question 4c); and
3. assessing the robustness of the technical capability of bidders over the 20 year project life (see our response to question 4d).

**5 e) Response:**

**EPQ based entirely on minimum threshold** – Please refer to our response to question 3c regarding the EPQ process.

**No limit on the number of bidders proceeding to ITT** - Apart from the market only being able to sustain a certain number of bidders, the supply chain is also a limiting factor that needs to be considered if the number of bidders proceeding to the ITT is unlimited. We have already seen 'fatigue' in the insurance market with a limited number of insurers some of which are concerned on pricing the current number of bidders for each OFTO and some becoming exclusive to one bidder. The more bidders at the ITT stage then the more acute the issues of the supply chain will become with only a limited number of insurance providers, O&M service providers, insurance brokers, and technical advisors etc. in the market. Whilst this could naturally limit the number of bidders at the ITT stage the impact on the supply market could lead to generic pricing removing innovation to the detriment of the consumer. It should also be noted even organisations that can run 'trees' have a limited capacity in this regard meaning that no bidder could end up with the optimal funding club, due to capacity constraints which would be to the detriment of the consumer.

**Removal of ITT section 3-6 and 8** - Ofgem has a duty of care to the developer to select a robust bidder at the ITT stage, therefore checking the robustness of a bidder at the PB stage is a high risk strategy which may result in a new entrant being unable to close the transaction or walking away with little time to replace due to the Generator

#### Commissioning Clause.

**Starting the ITT stage later** – The aim to start the ITT process later is to recover time from the PB process which in recent bids has been around 9 months in total. At least two months is required from the start of the Section 8A consultation to financial close. The main tasks in the preceding seven months are:

- Site visits which can take one month for the developer to arrange and are weather dependent. We consider that under this package that this would be undertaken at ITT, but a final site visit would still be required prior to financial close.
- Completion of Confirmatory Due Diligence (“**CDD**”). This is the CDD as described in the ITT bid supplemented by questions from the site visits, new information provided by the developer e.g. as built documentation and asset related issues that have arisen between ITT and financial close. In our experience if the developer engages fully this process is not the time limiting factor.
- Third Package Certification needs to start immediately on PB award. Given the EC will take two months to determine its recommendation the process will take at least four months to complete, allowing time for the successful bidder to provide the application to Ofgem and for Ofgem review. Overall this process will take a minimum of 3 to 4 months from PB appointment.
- OTSDUW completion report is required to be produced and approved by National Grid. The process at present is slow due to inexperience of the developer and National Grid commercial in understanding the process and can take several months to complete. This process could be streamlined if the required information in the Grid Code provided by the developer exactly matches the required information required by the STC.
- Transaction documents, on a recent project detailed negotiations on the Transfer Agreement only commenced after 3 months from the start of the PB stage. If the developer is willing to engage earlier several months could be saved in the PB timescale.
- Finance documents, the time required to finalise the finance documents depends on the complexity of the financing arrangements and if the finance documents are a ‘cut and paste’ or developed from new.
- A six week period is required from finalisation of the FTV, CDD and transaction documents to Credit committee approvals.
- Crossing, Proximity agreement and deeds of assignment will take time for the developer to obtain agreement with all the counterparties. Whilst this process can take place in parallel to the Section 8A consultation process a certain amount of progress will be expected prior to the commencement of Section 8A.
- O&M agreements will need to be finalised prior to credit committee approval and will need to take into account any output from the CDD process.
- Operational arrangements are required to be in place prior to Section 8A. This is a straight forward task which should not impact on timescales unless it is a new entrant having to develop all of the policies and procedures.

Overall if the developer engages quickly in the PB process and everything is as efficient as possible we could envisage the process taking 6 months (2.5m for transaction, finance, CDD, deeds of assignment etc., 1.5m for credit committee approval, 2m from commencement of Section 8A consultation process). It should be noted that this

timeline could equally well be achieved under the current OFTO tendering regime.

It should also be noted that once the transmission system is fully commissioned the construction teams stand down and move onto other projects which can result in a prolonged CDD process as obtaining answers from the correct staff can be difficult. This would be exacerbated under this option where ITT starts later.

**Increased bidder due diligence completed during ITT** – Our current approach is to undertake full DD at the ITT stage on all information that is available in the data room. Starting the process later may aid the level of data available and reduce the number of CDD items but this will only have a marginal impact on the DD process.

In order to complete the required DD at the ITT stage in order to complete the commercial discussion with the developer at the ITT stage would have to include site visits for all bidders which will raise a large volume of technical and snagging issues for the developer to agree and resolve during the ITT phase. As this process would involve multiple bidders we do not believe this meets the Ofgem objective to 'Undertake streamlined and efficient tender processes'. It would also lead to a significantly prolonged ITT phase and increase in bidding costs.

**Concluding commercial discussions earlier** – We understand the proposal is to agree all the main commercial documents with the developer at the ITT stage. This would mean agreement of:

- Transfer Agreement;
  - CoT, novations and other land issues;
  - Snagging works and other indemnities;
- Disclosure letter;
- Transmission Interface and Co-operation Agreement; and
- Vendor Guarantees,

prior to bid submission with the developer undertaking detailed negotiation with each bidder, which in this model could be a large number of bidders.

Negotiating contracts of this nature with multiple bidders will take time and be costly for the developer. For example on a recently completed transaction this process took over one month of intense discussions and negotiations at the PB stage with only one party. This would result in a significantly pro-longed ITT phase, as the developer would need to negotiate these items with each bidder individually, meaning that the ITT would need to start earlier to enable all negotiations to be concluded and still enable the transaction to be delivered prior to the end date of the Generator Commissioning Clause. We do not believe this meets the Ofgem objective to 'Undertake streamlined and efficient tender processes'.

**Unconditional TRS** - An unconditional price based on incomplete information in the dataroom will not be in the interest of the consumer as we consider this will increase the cost of the TRS due to unknown or incomplete risks being priced into the bid and a resultant higher cost of capital.

We do not consider that a potential benefit of such an approach would be that the length / complexity of the preferred bidder stage may be significantly reduced. Equity, credit rating agencies and lenders will still need a complete CDD prior to credit committee approval in order to understand the risks of the project and confirm pricing. The main discussions on the Transfer Agreement revolve around technical issues and snagging and as such once the CDD is completed will still be required. All other elements of the current PB stage would remain and as such a time period of at least 6

months will still be required even under the significant change model.

Further it is not clear what is meant by an unconditional price, for example all senior debt solutions will be linked to either a swap or gilt rate and a RPI swap rate, meaning that the price will vary as market rates change. Our understanding is that the unconditional price is not intended to cover such market movements, although if this were the intention a substantial buffer would need to be built in to manage the risk. Additionally it is not clear as to how items not available or unknown at the ITT stage will be treated as they become visible at the PB stage.

Reference is made to a pain/gain share mechanism, although no details are provided as to what events/changes this would apply to, other than uncommitted financing such as public bonds. If this relates to the spread required by investors in a public bond, this is largely outside the control of the OFTO and will be influenced by market movements. It would be very difficult to identify a spread above or below which pain/gain should be shared and also to identify what parameters should be taken into account in the pain/gain share mechanism.

We recognize that unconditional pricing may be appropriate in some sectors, but that is not the case for OFTOs as:

1. The OFTOs TRS is fixed (with very limited variability) and circa 80%-85% of the TRS is used to pay senior debt costs. Equity returns are very low due to certainty of the revenue streams resulting in very limited capacity for additional costs to be borne through a gain/pain share mechanism without equity returns being increased to accommodate such a mechanism; and
2. Other sectors are better able to accommodate a mis-priced bid never being delivered, without it having a material impact. The repercussions in an OFTO are material, as an alternative bidder will need to be selected to deliver the project, which will take time to complete, with the Generator Commissioning Clause providing a fixed end-point for generation. The likelihood being that in the event a bidder is unable to deliver its unconditional price the Generator Commissioning Clause will come into play prior to the asset being transferred.

**5 f) Response:**

Bid Bond: The bid bond will need to be sized appropriately:

- If too high it may increase costs to the consumer, and/or act as deterrent both to new entrants and existing bidders from bidding altogether; and
- If too low may not be a sufficient disincentive to prevent bidders walking away at preferred bidder stage.

With the size of the Tender Round 6 projects there will be significant equity at stake, meaning that it may be preferable to lose a bid bond rather than enter a 20 year project where equity returns are below the desired level e.g. on a project with an ITV of £500m and 90% gearing the equity will be £50m. A 10% fall in equity returns at the preferred bidder stage (equivalent to a 5-10bps increase in the cost of senior debt) would be the equivalent to £5m, indicating the bid bond would need to be greater than this.

Gain/Pain mechanism – see response to 5 e). In addition with regards to the pain/gain share mechanism on public bonds it may be more appropriate, and provide better value, to build a buffer into the spreads provided to bidders to use for their bids to accommodate the uncommitted nature of such financing and to incentivise bidders to investigate alternative ways to achieve unconditional funding.

**6: Are there other packages of change that we should consider that would better deliver against the objectives?**

**Response:**

The current tender process has led to a pool of robust, financially and operationally secure OFTOs. We therefore consider a more evolutionary change is required in order to meet the new objective of 'Undertake streamlined and efficient tender processes'.

This would take the form of:

1. rationalising the EPQ process (see our response to question 3c);
2. removing the duplication of questions between the EPQ and the ITT and within the ITT (see our response to question 4c); and
3. assessing the robustness of the technical capability of bidders over the 20 year project life (see our response to question 4d).

**7: With respect to the other tender process changes considered that could apply to either the current tender process or any of the potential packages for change:**

- a) **Does Vendor Due Diligence (VDD) in practice reduce the total cost of a tender process? Are there any benefits in broad VDD? Are there benefits in a more focused approach to VDD (for example a Certificate of Title)? Under what conditions and to what extent would bidders base their bid on VDD?**
- b) **Are there other cost-effective ways in which the bidder data room could be improved to the benefit of all parties? Are there specific ways to further standardise the structure?**
- c) **What changes, if any, should we consider to our current bond spread methodology? Would an appropriate pain/gain share mechanism for bond-financed bids allow us to fairly assess bond and bank-financed bids on the same committed finance basis?**
- d) **Do you consider that we could adequately rely on a more confirmatory approach to questions? Are there particular documents or questions we could consider not requiring the bidder to produce, but instead confirm? Are there particular documents/requirements that are better left to the PB stage?**

**Where possible, please quantify or describe qualitatively any benefits or burdens from this package of change.**

**7 a) Response:**

The current vendor Due Diligence ("DD") reports are of very limited benefit and a full due diligence process will be required by lenders and credit rating agencies who along with equity will not rely on the VDD reports. Please find below our thoughts on the due diligence reports:

1. **Legal DD**– An independent legal DD report will be required but if a comprehensive vendor legal DD report was produced against a template then this could reduce the number of legal DD questions and the bidders legal DD report could be shortened to a review of the vendor legal DD report thus

reducing costs of the tender process.

2. **Certificate of Title ("CoT")** – A certificate of title benefits all bidders by removing the need for each individual bidder to undertake property and land searches (£10k plus) during the ITT and PB stage of the process. We accept that our experience to date of CoTs has not resulted in reduced questions or time required. This has mainly been due to gaps in the CoT. If the CoT produced covered all land and/or insurances where gaps occurred the time to review and questions raised will be reduced.
3. **Technical DD** – Whilst the legal DD report is factual and lends itself to a vendor DD report the technical DD report can be subjective. Our experience of vendor technical DD reports is that they vary greatly in quality, are produced too early in the process and are too high level. A vendor technical DD report will also not be able to cover bidder specific areas such as availability, O&M assessment and assessment of residual technical risks. We also understand Ofgem use the technical DD report during the PB selection process. We therefore consider an independent technical DD report will always be required by lenders, credit rating agencies and equity.
4. **Insurance DD** – Each bidder will have its own insurance strategy and hence requirement for its own insurance DD report.

#### **7 b) Response:**

The suggested improvements to the data room in order to speed up the process are:

1. Ensure the data room is populated with the minimum level of data prior to opening such as:
  - a. all design reports;
  - b. all contracts (un-redacted for OFTO relevant data);
  - c. all seabed mobility studies and cable burial risks assessments;
  - d. complete CoT;
  - e. ITV with cost breakdown to asset level to allow insurance pricing and tax assessment; and
  - f. all non-conformance reports and details of any insurance claims, required for insurance pricing.

In addition a more structured filing system would aid speed of DD work and help reduce costs. The best developer over TR3/TR4/TR5 is Ørsted. This is due to sub folders within the main Ofgem structure being used with document names being a description of the document rather than just a number. This makes searching easier with only typically 50-150 files per folder over 1-3 pages which is manageable. When as-built drawing files do only contain large numbers of documents in a file, Ørsted provide a master document register. This is compared to other developers where 20 plus pages contain over 1000 documents some with only drawing numbers and no master document register making searching files extremely time consuming.

#### **7 c) Response:**

One option would be to put a buffer on the bond spread at ITT so all bidders use the same assumptions and bond financed solutions could be considered as robust as bank financed solutions. A pain/gain share mechanism, as detailed in the response to 5e, is difficult to see working well since not only would it be difficult to define the sharing mechanism but also as equity is a small proportion of overall TRS and any pain or gain



would have a disproportionate impact on equity returns (for example 5bps on senior debt is equivalent to 50bps on equity returns on a 90:10 geared project).

Other factors that should be considered in the bond methodology for TR6 are the size of the bonds, and whether an additional premium is required e.g. the public OFTO bonds to date have typically been over-subscribed by 2-3x with a total order book of £900m. For the much larger TR6 projects there is significantly less/no headroom which is likely to result in a price break. Such a price break has not yet been factored into the larger TR5 projects bond methodology. To ensure best value for consumers Ofgem should ensure that the consumer is not left exposed to this risk, the pricing of which will only become apparent close to financial close during the book-building process.

A further point Ofgem should consider is managing the market in a similar manner to how the NHS managed bond launches when the health PFI market was very active e.g. having two or more OFTO bonds launching in close proximity to one another could have a detrimental impact on investor appetite resulting in the latter bonds attracting higher pricing. Our suggestion would be that Ofgem manages the process so that there is at least a 3 month gap between the launch on each OFTO bond.

**7 d) Response:**

A confirmatory approach to questions may not provide the evidence of robustness. However a large volume of appendices are produced to support the bid document. It is unclear which of these appendices Ofgem find of value and review. One approach could be to make the appendices that are not reviewed by Ofgem as confirmatory and for Ofgem to then list the minimum level of appendices required.

**8: Do you think the approach of Ofgem, developers, and bidders to the tender process will need to change as projects become larger, further from shore and more expensive? What do you see as challenges from this change?**

**Response:**

Technically the assets are the same as earlier tender rounds e.g. AC technology; the only main difference will be the length of the offshore cable resulting in an increased statistical risk of cable failures during the lifetime of the project. Technical areas to consider for projects further from shore are:

1. Statistical increased risk of a cable failure with the need for increased spares holding due to deeper waters.
2. Need for efficient way to undertake offshore maintenance, e.g. offshore transmission assets only need to be visited for routine inspections once every three months, a one day visit may turn into a 3 day visit with the need for overnight sleeping facilities on the offshore platform (one day to sail out, one day for routine inspections, one day to sail back). The alternative is helicopter transport, or agreement with developer to use their staff on the floating hotels servicing the wind turbines.
3. HVDC (when it happens) will bring some challenges mainly in the area of the seawater auxiliary systems. However DTC have extensive experience of offshore HVDC systems from our German projects and do not foresee any major technical difficulties.

Financially we consider the larger projects (>£1bn) will present their own challenges (e.g. public bonds see response to 7 c) and the requirement for more innovative funding solutions which require a mix of different senior debt products (e.g. bank debt, JBIC and bond finance) in a solution. Also on such projects the requirement to be able to fund

120% of the ITV will be more of a challenge at the ITT stage and could result in worse value for the end consumer if not required.

**9: With respect to end of revenue term arrangements, where there continues to be a need for the OFTO, what factors should be taken into account when making decisions on OFTO revenue at the end of the normal 20 year term? When should we begin to make these decisions?**

**Response:**

Factors to be taken into account when making decisions on OFTO revenue at the end of the 20 year term are:

1. **Impact on insurance costs and deductibles.** Over a short revenue extension covering operation costs and returns, large insurance deductibles will not be viable where the TRS is much lower for the extension period thus significantly increasing the cost of insurance to the detriment of the consumer. Consideration should be given as to who is best placed to manage this risk.
2. **Asset replacement and condition assessment.** The majority of primary system assets (High Voltage) have technical design lives of 45 years with certain assets would benefit from a mid-life condition assessment. Most secondary system assets (Low Voltage) will reach 20 years e.g. it is not cost effective or in the consumer interest to replace SCADA and protection assets which have a design life of 15 years when operational experience shows these assets can function effectively to the end of the revenue period. If the revenue period is extended past 20 years then replacement of these assets should be considered from year 15. A typical schedule of work would be:
  - a. Offshore substation condition assessment at year 19 or 20 to ensure its asset life typically of 30 years can reach the extended revenue period;
  - b. Offshore substation corrosion system refurbishment. Typical paint systems are designed for 15 or 18 years. It is therefore envisaged that the offshore platform will need a full paint campaign. In addition sacrificial anodes typically designed for 20 years to protect the substructure from corrosion will require replacement;
  - c. Grid and supergrid transformers mid-life condition assessment to ensure the assets can reach their designed asset life of 45 years;
  - d. Transformer tap changer maintenance and overhaul;
  - e. Replacement of diesel generators which will be at the end of their asset lives; and
  - f. Replacement of SCADA and protection systems which typically have an asset life of 15 years.

Planning for an extended revenue period should begin as soon as the developer confirms its intention to extend the life of the wind turbines. If this is known in advance then planning could start as early as year 14 to allow assets with an asset life of 15 years to be replaced at year 16 onwards i.e. the optimal asset replacement time if the revenue period is to be extended by 5 or 10 years. However, this assessment could take place as late as year 18 with any asset replacement or paint campaigns etc. taking place in year 21.

**10: Is there demonstrable evidence that we should consider changing the default revenue period away from 20 years for future projects? If so, what would be the most appropriate revenue period?**

**Response:**

The optimal revenue period will be driven by finance rather than technical aspects of the project.

A longer revenue period may result in some secondary equipment e.g. SCADA, protection systems, diesel generators requiring replacement during the project life where this may not be required for a 20 year project life. Otherwise there is no real impact on an extended revenue period from a technical perspective.

Increasing the revenue period to say 25 or 30 years will have the advantage of spreading the depreciation of the assets over the longer term but there is a question whether the banking market can extend terms beyond 20 years, this would reduce liquidity in the market, increase pricing or result in a longer debt tail all of which would increase the TRS and potentially removing a source of competitive finance to the detriment of the consumer. Given the size of projects like Hornsea One a wide range of funding is likely to be required including both bond and bank funding.

There are also tax implications that a longer revenue period would present. At present as most windfarms are designed for 20-25 year asset life the majority of plant and equipment is classed as a short life asset attracting a higher capital allowances of 18%. If the revenue period was to extend beyond 25 years then all assets would have to be classified as long life assets attracting a capital allowance of 8%. This will increase the tax burden of the OFTO which would be borne by the consumer.

**11: Other policy changes without a direct Ofgem question**

**Response to CPI/RPI indexation**

We appreciate that central government is encouraging parties to focus on CPI as a measure of inflation rather than RPI, and that OFWAT has recently announced that it intends to move to CPI inflation from 2020.

We consider that moving to CPI inflation from RPI will impact both risk and achieving and demonstrating best value for the consumer.

**Risk**

The indexation of contracted services is typically linked to RPI. It may be unlikely the supply chain would amend the basis of inflation on their contracts, and a move to CPI inflation for TRS would cause a mismatch between the indexation of revenues and its costs that would add additional risk to the OFTO part of which will ultimately be borne by the consumer.

**Value**

A change to CPI may potentially impact bidding strategies. Under the TRS indexation regime since TR3, bidders have been able to select the proportion of TRS which could be inflated. This meant that bidders have the following options:

- fully inflating the TRS and either:
  - obtaining an RPI swap; or
  - utilising index linked debt instruments;

- inflating the TRS to provide a 'natural hedge'

This decision is driven by providing the most competitive NPV of TRS and therefore providing the consumer with the lowest cost. To date, across TR3, TR4 and TR5 best value has been achieved through fully inflating the TRS and obtaining an RPI swap.

Changing the inflation measure to CPI could well result in a different outcome as not only is the CPI swap market highly illiquid but it also lacks transparency making the benchmarking of terms difficult.

The lack of liquidity for CPI swaps is a direct result of UK Treasury continuing to issue either fixed rate debt or RPI linked debt, and to date has not issued any CPI linked debt, although it remains in consultation regards formally adopting CPI as the on-going measure of inflation for new index linked gilts. This results in there being no readily available benchmark for a CPI swap or reference gilt for a CPI index linked bond.

There is a basis market between RPI and CPI and thus many CPI products will be based on RPI and then take into account the basis market. In effect this could mean that two different financial products are required with execution spreads being paid on both. Certainly the majority of CPI linked transactions are bilaterally negotiated rather than there being priced in a transparent market. Due to the highly illiquid nature of these markets the execution spreads are likely to be higher than for RPI linked products resulting in higher costs to the consumer (it should be noted that in our experience a 1 basis point difference on an RPI swap has a greater impact on the TRS than a 1 basis point difference on senior debt).

Additionally due to the lack of liquidity and opaque nature of CPI products, at the current time, benchmarking rates to demonstrate that the consumer has received best value will be difficult (e.g. there is no generic CPI swap curve on Bloomberg).

We consider that a series of UK CPI linked treasury bonds need to be in issuance to create a more liquid CPI derivative market. At such a time a move to CPI linked indexation for OFTOs would be more appropriate.