

Energy UK response to Ofgem's consultation on Income Adjusting Event policy in Offshore Transmission Licences

8 March 2018

About Energy UK

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership encompasses the truly diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 730,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests £12bn annually, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

Introduction

Ofgem's proposals aim to maintain the viability of the OFTO regime and formalise the allocation of risk in relation to the cost of repairs to OFTO-owned assets. This ultimately pushes costs of repairs onto Developers¹ which changes the cost profiles of projects and could lead to increased consumer costs. We consider that the proposals in the consultation do not go far enough in relation to issues with OFTO arrangements and as such there is a high possibility of unintended consequences in the areas of investor certainty, policy integrity and in the insurance market. The matter should therefore be considered as part of a holistic review of the OFTO regime.

The OFTO regime is 9 years old in 2018, and it is anticipated that 5 tender rounds for OFTOs will be complete by the end of 2019. We believe that the OFTO regime would benefit from a critical evaluation of its successes since its inception, and an identification of areas where the regime as a whole could utilise lessons learned to build an even more robust and efficient regime. Industry is proposing an offshore wind Sector Deal which would include a review of market arrangements. This would also include the creation of a Taskforce to inform future grid planning and regulations for large scale systems and offshore transmission. Consumer benefits could be realised from undertaking such a review.

In addition, should Ofgem decide to proceed with making changes prior to a holistic review then we believe that the following considerations are critical:

- 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?**

¹ As used by Ofgem in the Renewables Obligation guidance, we use the terms 'Developer' and 'Generator' interchangeably throughout this response with the same meaning.

- The consultation states that the licence effectively provides “insurance of last resort” for existing OFTOs (page 5). This effectively means existing wind farm developers acting as ‘pseudo-insurers’ which risks affecting investor certainty in the offshore wind industry in the UK. Placing the costs of this risk on offshore wind farm owners while they are unable to control or mitigate risk is a windfall loss to existing generators and changes the cost profile of projects. This could increase costs of future offshore wind generation due to all Developers acting to protect themselves against an event that will ultimately only impact a small sub-set of projects. It is not clear therefore, that the proposal will actually result in the overall best outcome for consumers.
- With reference to Ofgem’s statement that significant pass-through costs from OFTO to generators, as a result of IAE policy being applied, should be an incentive for generators to build fit-for-purpose assets, innogy[HT1] highlights that generators are already under significant pressures to build high-quality assets. The loss of revenue from electricity sales and any subsidies alone should be a sufficient incentive to develop critical export infrastructure. Reputational pressures also apply in this regard.
- Ofgem’s policy for ‘future OFTOs’ should apply only from TR6 at the earliest, not TR5. Retroactively applying policy to projects in TR5 is likely to be damaging to those projects and to the business cases of related assets and future investor confidence.
- The consultation fails to address how efficient repairs would be incentivised. All pass-through costs from OFTO to third parties (e.g. Developers) should be scrutinised by Ofgem to ensure that the OFTO carries out repairs in an economic, efficient and reasonable fashion, in a similar way to the costs of asset transfer from Developer to OFTO. Allowed and disallowed costs must be transparent to the party to whom the costs are passed to, so that they may challenge these where they see fit. Timeliness of repairs must also be incentivised. To date we are not convinced that the ‘availability incentive’ for OFTOs has incentivised timely repairs.
- Energy UK agrees with Ofgem that OFTOs must be appropriately incentivised to procure and keep insurance wherever possible. We also support a deductible being applied to “uninsurable” events. Ofgem’s proposals seem reasonable at £5m or 30% of the cost (whichever is higher). We would not support a deductible of less than 30%.

Warranties & indemnities

- The open letter consultation also proposes minimum protections that developers should offer to OFTO licencees. It is not the role of the regulator to involve itself in the commercial arrangements of either i) developers with their contractors, or ii) between developers and the OFTOs. Warranties are already provided, and we ask the regulator to therefore provide further information on why existing provisions are not good enough.
- Cable manufacture and laying is a complex process, therefore mandating a warranty to the OFTO faces a number of challenges. It is not clear how an Ofgem-defined warranty could be guaranteed on every project. It could fall to the developer to provide a warranty or make up the gap between the warranty offered and that which Ofgem demands at their own cost.

Ofgem proposes minimum warranty/ indemnity provisions as part of the IAE policy. We ask Ofgem to clarify the circumstances in which it envisages protection over and above the “minimum” may be required and what it considers any such increased protection may consist of.

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

If the solutions proposed in the open letter are to be pursued, we would like to request clarification around specific points and definitions to ensure a common and consistent approach across industry:

- The open letter makes references to both cables and assets. Ofgem needs to be clear where they are referring solely to cables (as in the case of the warranty proposals) or the entire offshore transmission asset (for application of the wider IAE policy as per the licence condition?). If cables are the regulator's concern, will other assets be excluded? We suggest that each case is assessed upon its own merits and ask Ofgem to make a statement that specific cable failures do not set precedents for all future cable failure issues which may have entirely different root causes.
- How is "first event of asset failure" defined? This could refer to a specific failure of a type of cable which is then blanket assumed as "first failure" across the whole industry, or it could refer to the specific failure of one specific cable at one wind farm for a specific reason. We believe the latter is more appropriate than the former.
- The definition of "uninsurable" must be clear and robust and "exceptional circumstances" on page 5 also requires defining. This is an area of obvious concern for the potential to create unintended consequences. The IAE policy around "uninsurable" must require that OFTOs which believe they may be dealing with an "uninsurable" situation provide robust evidence of such before any pass-through of costs (less deductible). This includes providing conclusive evidence that insurance was unavailable in the market in line with the definition.
- Second events of failure should not automatically be considered IAEs. They must be assessed on their merits, whether "uninsurable" or not.
- Cable contracts generally foresee a handover at 'sectional completion' which is following the successful installation. Contracts will each have their own definition of the handover process. We would therefore welcome some more detailed drafting of "handover of completed assets to Developer". This drafting should be discussed and refined with industry to ensure there are no unintended consequences due to the retroactive impact of the policy on signed contracts - particularly for TR5.
- It is not possible for Developers to retroactively procure insurance cover for projects in TR5 (which are under construction). Insurance contracts are already in place, and the insurance market will not allow projects that are in construction or post-construction to amend their construction insurance policies.

Finally, does "Estimated Transfer Value" refer to Initial Transfer Value or Indicative Transfer Value?

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

- OFTOs must be able to demonstrate to Ofgem that Operation & Maintenance (O&M) is ongoing and has been undertaken since the time of asset transfer in line with good industry practice.
- Ofgem should consider whether pass-through costs from IAEs are best passed-through to Wider TNUoS as opposed to Local TNUoS, as this could lead to the consumer being better off overall. This would result in costs only being passed-through to the consumer in the rare event of an IAE, rather than the consumers paying for the risk-added value (for example through higher CfD bids). As long as Ofgem can ensure that OFTOs are incentivised to procure and keep comprehensive insurance - and that any pass-through costs as a result of IAEs are appropriately scrutinised - this could be an opportunity to protect consumers from increased costs related to risk perception.
- We suggest that the £1m value which must be demonstrated as part of Paragraph 15 of the IAE Condition, be reviewed and amended to a more appropriate figure. The £1m has been fixed in the STC without any links to inflation, and is therefore out of date.

Energy UK welcomes the opportunity to further discuss the points raised within this consultation with Ofgem. Should you require further information or clarity on the issues outlined in this paper then please contact:

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