

Office for Gas and Electricity Markets  
10 South Colonnade  
Canary Wharf  
London  
E14 4PU

17 May 2018

For attention of James Norman

Dear James

### **Offshore Transmission Owner (OFTO) Tender Process – Consultation for Future Tender Rounds**

Equitix Limited (Equitix) welcomes the Office for Gas and Electricity Markets' (Ofgem's) Consultation for Future Tender Rounds (the Consultation) which is timely for the forthcoming Tender Round 6 (TR6) procurement, taking into consideration:

- the increased size and corresponding transfer value of the TR6 OFTO projects;
- the anticipated total funding requirement of the TR6 OFTO projects and implications for bidders' financing strategies;
- improvements in technology, particularly wind turbine generators, potentially resulting in an extended demand for the OFTO assets beyond 20-years; and
- Ofgem's Income Adjusting Event (IAE) Policy in Offshore Transmission Licences Consultation (the IAE Consultation) and the importance of clarity regarding uninsurable latent defects.

Equitix was pleased to participate in the TR6 Consultation workshop held at Ofgem's offices on Tuesday 1<sup>st</sup> May and, following those discussions, we have set out below our responses to the questions contained in the Consultation document.

**Question 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?

Equitix agrees with the key drivers for change identified by Ofgem, in particular:

1. the OFTO projects in TR6 (and beyond) are larger, more expensive and further from shore which may make these assets more complex to operate. In turn, this may present an opportunity to explore new funding models and/ or change the way in which Operations and Maintenance ("O&M") services are delivered;
2. to ensure that future tender rounds continue to deliver value for money, drawing on lessons learned from operational OFTOs and other sectors where appropriate; and
3. ensuring that OFTO licensees are sufficiently robust (including O&M subcontract partners) to effectively and efficiently manage the OFTO assets.

Equitix believe that Ofgem should consider an additional key driver in shaping TR6 and future tender rounds, namely technological advancements in the offshore wind industry. As evidenced

by our recent OFTO interactions with windfarm developers, it is likely that they will plan to operate the windfarms beyond the current revenue period of 20 years.

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

Equitix agrees that the objectives of Ofgem's review are appropriate, in particular:

1. to deliver transmission infrastructure on a timely basis, and ensure that OFTOs are robust and can deliver transmission services successfully during the revenue period;
2. provide best value to consumers through the competitive process;
3. attract new entrants into the sector (provided that they bring the requisite skills and experience to satisfy objective 1 above); and
4. undertake a streamlined and efficient tender process.

Equitix would like to confirm that Ofgem's objective to undertake a streamlined and efficient tender process is intended to remove inefficiencies/ overlap between the Enhanced Pre-Qualification (EPQ) and Invitation to Tender (ITT) requirements, reduce the time and cost of participating in the tender process (both for Ofgem and bidders) and provide clarity on key bid assumptions. While Equitix is broadly in agreement with this objective, Ofgem must ensure that it does not dilute the robust and rigorous assessment of bidders during the EPQ and ITT stages. In particular, given the recent number of onshore and offshore cable failures, Equitix believes a key objective should be that bidders not only demonstrate they have the necessary experience to manage OFTO assets during steady state operations, but also that they are able to mitigate, respond to and manage outages to minimise down time should a fault occur.

**Question 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 the EPQ or ITT?
- c) Do you have any other specific feedback on the existing tender process?

a) Equitix eagerly awaits the outcome of Ofgem's IAE Consultation. We are concerned that, as currently drafted, Ofgem's proposals place a greater risk on OFTOs and could lead to the OFTO being less operationally robust as a result of:

- imposing an IAE deductible for each and every claim (irrespective of whether the root cause was an inherent defect which occurred prior to asset transfer and which could not have been identified through technical Due Diligence (DD) at the ITT stage);
- imposing a variable deductible set at the higher of £5m and 30% of the claim; and
- proposing a retrospective policy change (i.e. that it will apply to operational OFTOs) which were not structured to accommodate such measures and which may potentially impact operational and financing arrangements.

The above factors are likely to have a material impact on financing terms, the OFTO's credit rating, and costs due to the additional liquidity required to meet the IAE deductible. We would therefore suggest the developer, as the most appropriate party to bear responsibility for defects, should take this risk by:

- providing a prescribed minimum level of defect warranties from contractors (as currently there is no incentive on the developer to secure defect warranties from contractors); and/ or
- taking this risk by providing stronger warranties within the Transfer Agreement; and/ or
- Ofgem should cap the number of major failure deductibles borne by an OFTO to ensure best value pricing. In particular, Ofgem should be prescriptive about the base warranties (specifically condition of asset warranties) that developers are required to provide in the Transfer Agreement.

Equitix is supportive of stronger contractual protection in the form of a 10% retention (excepting subsea cable failures) plus an additional retention (project specific) to allow for subsea cable repairs. Equitix believe the retention should be held for at least the first five years following asset transfer, stepping down over the following five years. This would provide appropriate protection to the OFTO to cover defects which are not the result of poor O&M or external factors (such as anchor drags), but due to latent defects (beyond the OFTO's control) and would incentivise the developer to consider the whole life costs during design and procurement of the construction packages, and hand over a defect free asset.

b) given the relatively low level of planned O&M undertaken by the OFTO, coupled with a relatively mature OFTO market, we do not believe that a 'Carillion' situation would have a material, long-term impact on the OFTO. We would expect that the operational security package required by senior lenders already mitigates this risk and that replacement contractors (either 'turn key' providers or, if necessary, under a multi-contract approach) are readily available in the OFTO sector.

c) generally, Equitix believes that the tender process is effective at identifying robust, deliverable and competitive bids. However, we believe that the existing tender process could be improved through the following:

- ensuring that developers follow a standard data room structure (suggest Ørsted structure as a benchmark): this will enable bidders and their advisors to locate documents more easily;
- having better structured, informed and suitably attended meetings with the developer: to ensure efficient use of resources and to facilitate a meaningful dialogue, to allow us where possible to confirm assumptions, clarifications and positions to help develop our bids and associated pricing;
- re-assess bond pricing methodology to ensure deliverability and robustness of pricing is fairly evaluated against all funding solutions and across bids;
- provide clarity on regulatory arrangements at the end of the revenue period to maximise residual value assumptions and potentially facilitate funding beyond the current initial revenue period; and

- provide more informed and targeted feedback following the Preferred Bidder (PB) announcement that allows bidders to respond in time for the following tender round; commitment to timetable and milestone dates to allow bidders to efficiently manage our resources to effectively deliver.

**Question 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.

Equitix believes that the moderate change package could lead to improvements from the current tender process. However, Equitix's strong preference is for the current EPQ approach to be retained, with Ofgem selecting a shortlist of up to five bidders, with a maximum of three bidders for each project taken through to the ITT stage. We would be happy to bid against a longer list of bidders at ITT stage, however we would query whether there is sufficient expertise in terms of legal, technical, insurance and financial advisors, and funder's trees to support more than five bidders at the ITT stage.

We do think there is an element of repetition that could be removed from the ITT. Some of the questions in the ITT are confirmed through re-issuing the EPQ and/ or could be confirmed through confirmatory responses (e.g. nothing has changed or updates to be provided where required).

It may be possible to remove the wordy responses required in the ITT (e.g. Section 3, 4, 5 and 6) by requesting specific documents (which would normally be appended) to provide the detail of how we intend to finance and operate the asset, such as:

- Section 3 – Takeover/ Mobilisation plan;
- Section 4 - Asset Condition Assessment, Asset Management strategy (including inspection plans, repair plans, contingency plans, risk register, resourcing), Maintenance programme and cost plans;
- Section 5 - Decommissioning plan; and

- Section 6 – summary table of funding options assessed, finance strategy/ preferred funding option, term sheets, DD reports, confirmatory DD at PB, and funders letters of support.

All of which will need to provide the details as set out by Ofgem and can be evaluated. In this way Ofgem can identify the key documents that they require for evaluation, whilst avoiding:

- Bidders having to provide words to describe these documents;
- Ofgem having to review the summaries of these documents; and
- Unnecessary appendices.

In practice, the bid is written and then summarised in Section 8 to demonstrate how our pricing assumptions link back to our financial and technical proposals in sections 3, 4, 5 and 6. We would suggest that the ITT could essentially be reduced to confirmation/ update of the EPQ together with a list of other confirmations (as required by Ofgem) and a schedule of project specific documents (as set out above) so only the current Section 7 and 8 bid responses would be required?

**Question 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.

We think that by having a minimum threshold for the EPQ, and allowing more than five bidders will introduce a number of issues, including:

- insufficient number of suitably experienced advisers and funder resources to support all the bidders, who will not have the available trees or appetite at the ITT stage to provide the detailed DD required for cost certainty or who will increase abort fees due to the decreased chances of each bidder being awarded PB status;
- Increased resourcing and costs for both Ofgem and bidders who will seek to recoup costs through their successful bid recovery and pass on to the consumer; and
- Bidders would not want to participate in a costly, resource intensive ITT with more than five bidders.

We do not think that Section 8 should become a threshold, nor final determination of PB based on Tender Revenue Stream only. In our view this will erode the incentive for bidders to price robustly, and the OFTO may then not be able to maintain appropriate availability, which will not provide best value to customers. These assets have proven to be complex, with each OFTO having bidder and project specific pricing assumptions. We think the 40% robustness evaluation is an essential element of the bid process to ensure a balance between cost and risk, to ensure the OFTO is deliverable, and to allow Ofgem to determine if lowest price represents the best value over the long term of the project.

Similarly, whilst we recognise it will reduce the resource burden for Ofgem's evaluation, we do not think that only assessing the two lowest bidders will necessarily identify best value.

We are unclear how a price can be offered 'unconditionally' when the financial markets may move. There may also be other elements that change between ITT submission and Financial Close (FC) which are outside of the bidder's control, and therefore difficult to price. Without submitting the details normally included in the ITT in relation to how the OFTO will deliver the O&M requirements and manage/ price risk it would make it extremely difficult for bidders to demonstrate (and for Ofgem to evaluate) the impact of such changes, whether a positive or negative impact on price, and to apportion pain/ gain share. We therefore do not understand how the bid bond or pain/ gain share will work in practice, which from our perspective are not necessary as our reputation in this market is dependent on delivering on our ITT/ final bid commitment.

We agree the ITT stage should only start once there is sufficient information in the data room, and would suggest Ofgem agree a key deliverables schedule with developers to suit the bidders DD process, to ensure developers are aligned and bought in to the bidding programme and DD process. We would also recommend Ofgem confirm the filing structure and use a data room with a more sophisticated search function (e.g. Intralinks, Merrill, A-site), to allow bidders and their advisers to easily locate and review documents. However, it is recognised that there is a huge volume of information to review, which can only be realistically reviewed in tranches and in a sequential process (i.e. design, construction, commissioning), therefore we would not recommend delaying the ITT stage unnecessarily, and waiting until everything is finished – which from our experience is often much later than originally planned, and could impact on the Generator Commissioning Clause and, ultimately, delay FC.

Given the process that bidders need to go through with funders, including finalising DD reports, credit rating, funder DD and credit committees/ bond road shows, combined with Ofgem's section 8A process for license grant, we do not think that there is much scope for the parties to close the projects any faster than six months. In addition, in order for many of the activities to progress as proposed under the significant change package, bidders will need to commit considerable additional resources and expend significant cost at risk prior to PB (normally spent at PB), which raises similar issues (as explained earlier in our response) relating to multiple bidders unnecessarily having to carry out the same tasks, pressure on resources, appetite to bid and ability to deliver value for money.

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

N/A

**Question 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 focussed 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?

- a) historically, Equitix is of the view that Vendor Due Diligence (VDD) has not reduced the total cost of bidding. Often, the VDD reports are outdated (typically produced six - 12 months before the tender process has commenced) and omit contract variations, construction issues (such as burial depths for the cables) and title information. Furthermore, the vendor's advisors owe no duty of care to bidders (or senior lenders) which requires us to undertake our own technical, legal, tax, and insurance DD.

However, we think the bidding process timing should allow for the developer to produce a technical VDD report for the design and the procurement phases of the project (recognising the testing, commissioning and as-built information would not be complete). Provided bidders can place reliance on the VDD report, this could reduce both the amount of information required in the data room and associated work for bidders to review.

Also, as discussed with Ofgem, we think that the legal VDD reports should obviate the need for bidders to undertake their own legal DD, and that a certificate of title issued by the developer would be efficient and save money, rather than each bidder having to carry out the same process. It would save considerable time and cost if the vendor were to produce a certificate of title (suitable for funders) and make this available to all bidders at the ITT stage. Currently, there is a significant duplication of work as each bidder will have to undertake its own legal review of title information. Equitix estimates that removing this element of work would reduce our legal fees by c. £30k to £50k for each project.

b) as highlighted in our response to question five, we suggest Ofgem works with developers and bidders to create a key deliverables schedule with the structure of each report dictated by Ofgem to ensure that bidders have the information needed to develop an informed and robust bid. A key deliverables schedule would ensure that there are no gaps in the information provided by developers, and that they are aligned with the bidding process. It would also be helpful if Ofgem mandated that developers follow a standard data room structure to enable bidders to locate documents with ease. Equitix believes that there are more user-friendly data rooms equipped with more sophisticated search functions (such as Intralinks and Merrill) which would allow bidders and advisers to more easily locate and review documents.

c) Ofgem should consider providing credit spreads for a wider range of credit ratings. Currently, Ofgem only mandates the credit spreads bidders should adopt for A3 and Baa1 (Moody's) ratings. Equitix would recommend providing credit spreads for A3, Baa1, Baa2 and Baa3 rated bonds to:

- prevent bidders from 'gaming' by structuring projects to achieve a rating where the credit spread is not mandated by Ofgem; and
- recognise that it may provide better value for money to structure the project to achieve a lower credit rating (i.e. the increased credit spread may be offset by less onerous senior debt covenants).

Equitix believe that it would be difficult to introduce a pain/ gain mechanism for listed bonds since there are a wide variety of factors which are beyond the control of the OFTO which could result in changes to the credit rating/ spreads at FC, including:

- Ofgem: changes to the regulatory environment and policy decisions, such as IAEs for latent defects, could have an adverse impact;
- Market: divergence in financial markets; and
- OFTO asset: changes to the condition of the assets, such as a cable fault, would be beyond the control of the OFTO.

d) Yes, we think Section 8 is the descriptive section of the bid where we set out our approach to mitigating and pricing risk. The rest of the bid can either be confirmation of what we included in the EPQ, plus project specific documents including financial model, committed funding structure and technical documents setting out how we will effectively mobilise, takeover, operate and decommission the asset.

**Question 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?

As projects become larger and more expensive it is likely that debt capital markets will play an increasingly prominent role in funding the acquisition of OFTO assets. The debt capital markets



represent a very deep pool of capital and is a tried and tested means of funding OFTOs, as evidenced by the Greater Gabbard, Gwynt y Môr, West of Duddon Sands issues and most recently the Dudgeon bond launch. A key driver for the credit spread of the bond will be the credit rating issued by one of Moody's, Standard & Poor's or Fitch. Rather than a preliminary rating assessment service (RAS) (or equivalent) being optional at the ITT stage, we believe Ofgem should require all bidders who propose to fund the acquisition through listed bonds obtain a RAS. This will add to the robustness of the bids and provide Ofgem with confidence that bidders' proposals are deliverable.

It may also be necessary to re-visit the liquidity held by the OFTO (such as reserve accounts) if the cost of repairing a fault increases significantly as a result of operating in deeper waters.

**Question 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?

We think Ofgem should provide a clear methodology to calculate revenue beyond the initial 20-year period during bid stage, to maximise the residual value for customers given the likely demand for the windfarm to continue generating. Generators should be able to confirm their base case during the tender process (e.g. Race Bank 25 years).

If applied retrospectively, this will need to be confirmed by year 10 as this will affect the decommissioning plan and reserving requirements, and inform decisions by BEIS and the windfarm owner.

Decisions should be finalised by year 15, to allow review of the asset life, and appropriate maintenance and lifecycle plans agreed and carried out over the next five years to suit the extended period of operation.

**Question 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?

We consider that there is demonstrable evidence, given the sufficient advances in technology and design life, considerable developer interest to continue to generate after the 20-years (or repower), together with funder appetite to lend for a longer term.

The primary asset design life could be 30-40 years, with some secondary assets requiring additional maintenance or lifecycle replacements. Each project would have to be assessed in terms of the asset components of the design, maintenance and lifecycle requirements, which we would expect to range from 25 -35 years.

Please do not hesitate to contact Andy Rymer should you wish to discuss any of the feedback or arrange further meetings and to participate workshops.

We look forward to hearing from you and to the outcome of the consultation.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Peter Roughton', with a long horizontal flourish extending to the right.

Peter Roughton  
General Counsel  
**Equitix Limited**