

# Decision

## Policy – Income Adjusting Events in Offshore Transmission Owner Licences

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**Contact:** Yvonne Naughton, Manager, Offshore Transmission

**Team:** Offshore Transmission

**Tel:** 0141 331 6006

**Email:** [Offshorelicensing@ofgem.gov.uk](mailto:Offshorelicensing@ofgem.gov.uk)

This document discusses and replies to stakeholder responses to Ofgem's Income Adjusting Event open letter of 6 February 2018 and clarifies Ofgem's policy relating to the operation of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) (the **IAE Condition**) in the Offshore Transmission Owner licence. In particular, it clarifies Ofgem's approach to Income Adjusting Event claims in the context of asset failures caused by latent defects (in particular in circumstances of uninsurability) and sets out Ofgem's intention to make modifications to the IAE Condition in the Offshore Transmission Owner licence.

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## Contents

<b>Contents</b>	<b>2</b>
<b>Foreword</b>	<b>3</b>
<b>1. Introduction</b>	<b>4</b>
Our process	5
Related publications	6
<b>2. Policy summary</b>	<b>8</b>
Confirmation of policy	8
Policy positions	8
Clarification	9
<b>3. Policy applicable to the IAE Condition</b>	<b>10</b>
Defining uninsurability	10
Application of deductible to Uninsurable IAE Claims	19
Protections to be offered by Developers	22
Modification of limb (a) of Paragraph 15	24
IAE threshold increase	26
<b>4. Other views raised by respondents</b>	<b>27</b>
Impact on transmission use of system charges	27
Additional issues	28
<b>5. Next steps</b>	<b>34</b>

## Foreword

In 2009, the Government introduced the regulatory regime for offshore electricity transmission to connect significant amounts of renewable offshore generation to the onshore electricity network.

Offshore Transmission Owners (**OFTOs**) are appointed through a competitive tender process. OFTOs are granted an offshore transmission licence (**OFTO Licence**) with a fixed 20 year revenue term (25 years from tender round 6 onwards).

The offshore regime is flexible and delivers lower costs to consumers – we estimate the offshore regime has saved between £0.7bn and £1.1bn over the first three tender rounds as stated by the independent evaluation by Cambridge Economic Policy Associates (CEPA) – and makes a major contribution to the UK's renewable energy targets. The Authority have licensed 17 OFTOs with a further seven in the pipeline. The first five tender rounds will deliver £5bn in investment and 4.6GW connected renewable generation.<sup>1</sup>

As a result of a number of subsea cable failures, some insurance providers have limited or withdrawn insurance protection for certain failures. In response, we sought views on the policy we have applied to paragraph 15(c) of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) (**the IAE Condition**) of the OFTO Licence, and on the operation of the IAE Condition more broadly, and asked whether the IAE Condition should be strengthened, for both existing and future OFTOs. We wish to ensure that the OFTO Licensee responds in the most appropriate way in order to protect the interests of consumers when the risk associated with OFTO assets becomes uninsurable.

We have considered the responses to our open letter of 6 February 2018, and set out our policy position in this document.

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<sup>1</sup> [See our latest infographic.](#)

## 1. Introduction

- 1.1. Offshore Transmission Owners are appointed by Ofgem through the offshore transmission tender process, and are granted an offshore transmission licence (**OFTO Licence**). The OFTO Licence provides the Offshore Transmission Owner (**OFTO**) with a fixed 20-year revenue term (25 years from tender round 6 onwards). Although the revenue is fixed, the licence framework recognises ongoing uncertainty through the inclusion of mechanisms that allow for future adjustments for certain events. For example, where the Authority<sup>2</sup> considers that an event is an income adjusting event (**IAE**).
- 1.2. The IAE provisions are set out in paragraphs 14 to 24 of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) (the **IAE Condition**) of the OFTO Licence.
- 1.3. The general purpose of the IAE Condition is to provide protection to OFTOs for identified unexpected costs arising from certain low probability but high impact events. Paragraph 15 of the IAE Condition (**Paragraph 15**) defines what constitutes an IAE, as follows:

*An income adjusting event in relevant year t may arise from any of the following:*

- a. an event or circumstance constituting force majeure under the STC;<sup>3</sup>*
- b. an event or circumstance resulting from an amendment to the STC not allowed for when allowed transmission owner revenues of the Licensee were determined for the relevant year t; and*
- c. an event or circumstance other than listed above which, in the opinion of the Authority, is an income adjusting event and is approved by it as such in accordance with paragraph 21 of this licence condition,*

*where the event or circumstance has, for relevant year t, increased or decreased costs and/or expenses by more than [£500,000]/[£1,000,000] (the "threshold amount").<sup>4</sup>*

- 1.4. Events falling within limbs (a) or (b) of Paragraph 15 are expressly defined and do not involve the exercise of the Authority's discretion in determining whether an IAE has arisen. However, in determining whether an event is an IAE within the meaning of limb (c) of Paragraph 15, the Authority must exercise its discretion, which requires the application of a policy to be set by reference to our statutory duties, in particular our principal objective to protect the interests of existing and future consumers.
- 1.5. We have made decisions on four IAE claims from three OFTOs: Blue Transmission London Array Limited on 27 October 2016 (the BTLAL decision<sup>5</sup>); Thanet OFTO

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<sup>2</sup> Reference to 'we', 'Ofgem', 'the Authority' and 'our' may be used interchangeably throughout this document to refer to the Gas and Electricity Markets Authority.

<sup>3</sup> The System Operator Transmission Owner Code.

<sup>4</sup> Referred to as the 'STC Threshold amount' in licences granted under tender rounds one and two.

<sup>5</sup> <https://www.ofgem.gov.uk/publications-and-updates/publication-our-determination-relation-notice-income-adjusting-event-blue-transmission-london-array-limited>

Limited in 31 May 2017 (the Thanet decision<sup>6</sup>); Gwynt y Môr OFTO plc on 31 May 2017 and 20 September 2017, respectively (the GyM SSEC1 decision<sup>7</sup> and the GyM SSEC2 decision)<sup>8</sup>. The latter decision is currently the subject of a judicial review.

- 1.6. In our IAE decisions to date, we considered the following four factors when assessing whether each event was an IAE under limb (c) of Paragraph 15, and will continue to assess claims under limb (c) of Paragraph 15 in accordance with these four factors:
1. whether the OFTO knew of the event or circumstance before it arose or ought to have known of it
  2. whether the risk of damage of that type was reasonably foreseeable (even if the particular way in which the damage has occurred may not have been)
  3. whether there are nevertheless exceptional factors in the relevant case that mean that the event or circumstance, or its consequences, could not have been reasonably foreseeable, and
  4. the ability of the OFTO to manage the risk or impact by putting in place and pursuing risk management arrangements such as insurance, commercial recourse against third parties and/or operating practices.
- 1.7. In each of our IAE decisions to date we have made clear that, similar to any other transaction involving a purchase of assets, an OFTO should enter into the transaction of acquiring OFTO assets with the awareness that it is assuming any risks arising from damage or defects that it has not been able to discover through its due diligence. The offshore regime was not designed to insulate OFTOs from all such risks. We consider that a latent defect is a type of risk that is reasonably foreseeable, and OFTOs should put in place appropriate commercial arrangements to manage or absorb these risks.
- 1.8. Notwithstanding this, the GyM SSEC2 decision allowed certain costs arising from a latent defect (net of amounts recovered through commercial recourse and a sum equivalent to the insurance deductible) to be passed through as an IAE on the grounds that the risk had most likely become effectively or practicably uninsurable. In response to a number of cable failures, some insurance providers had in practice limited or withdrawn insurance protection for such failures which limited the ability of OFTOs to put appropriate commercial arrangements in place to manage or absorb these risks.

## Our process

- 1.9. On 6 February 2018, we published an open letter (the **IAE Open Letter**).<sup>9</sup> In that letter, we explained the IAE Condition, summarised the IAE decisions we have made so far, and identified the policy concerns that have arisen, particularly in the context of cable failures caused by latent defects. We described the interaction of the IAE Condition with developments in the insurance market for such risks. The letter also

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<sup>6</sup> <https://www.ofgem.gov.uk/publications-and-updates/thanet-ofto-limited-determination-under-paragraph-23-amended-standard-condition-e12-j3>

<sup>7</sup> <https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-mor-ofto-plc-determination-under-paragraph-23-amended-standard-condition-e12-j3>

<sup>8</sup> <https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-mor-ofto-plc-determination-under-paragraph-23-amended-standard-condition-e12-j3-0>

<sup>9</sup> <https://www.ofgem.gov.uk/publications-and-updates/open-letter-consultation-income-adjusting-event-policy-offshore-transmission-licences-0>

set out the approach we were considering in respect of the allocation of risk for uninsurable latent defects for both existing and future OFTOs. We invited comments from all interested parties. In particular, we asked:

Q1: 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?

Q2: Do you consider that there are likely to be any other unintended consequences from implementing the proposed IAE policy as suggested above?

Q3: Is there anything else that Ofgem should take into consideration when deciding on the future policy for IAEs?

1.10. The opportunity to respond to the IAE Open Letter closed on 6 March 2018.<sup>10</sup> We received 19 responses to the IAE Open Letter, four of which were confidential. Of those responses, eight responses came from OFTOs, eight came from offshore generators and three were from other industry participants. We have published all non-confidential responses on our website.

1.11. Since the IAE Open Letter was issued, we have also met with a number of industry participants to further discuss our proposals, including:

- bidders
- offshore developers<sup>11</sup> and generators
- the Department for Business, Energy and Industrial Strategy
- a rating agency
- insurance providers, and
- other interested stakeholders.

1.12. This is in addition to the analysis, consultations and considerations that occurred prior to developing the policy proposal set out in the IAE Open Letter.

## Related publications

Link to our consultation: <https://www.ofgem.gov.uk/publications-and-updates/open-letter-consultation-income-adjusting-event-policy-offshore-transmission-licences-0>

Links to previous IAE decisions:

<https://www.ofgem.gov.uk/publications-and-updates/publication-our-determination-relation-notice-income-adjusting-event-blue-transmission-london-array-limited>

<https://www.ofgem.gov.uk/publications-and-updates/thanet-ofto-limited-determination-under-paragraph-23-amended-standard-condition-e12-j3>

<https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-mor-ofto-plc-determination-under-paragraph-23-amended-standard-condition-e12-j3>

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<sup>10</sup> <https://www.ofgem.gov.uk/publications-and-updates/open-letter-consultation-income-adjusting-event-policy-offshore-transmission-licences-0>

<sup>11</sup> 'Developer' is defined in The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015, Regulation 3.

<https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-mor-ofto-plc-determination-under-paragraph-23-amended-standard-condition-e12-j3-0>



## 2. Policy summary

### Confirmation of policy

- 2.1. Following consideration of the responses received to our open letter dated 6 February 2018 (**the IAE Open Letter**)<sup>12</sup>, and our internal analysis and further discussions with stakeholders, we will continue to provide uninsurability protection under paragraphs 14 to 24 of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) (**the IAE Condition**), where the Offshore Transmission Owner (**OFTO**) is unable effectively to mitigate the effects of latent defect risk (including, through no fault of its own, that risk becoming Uninsurable as defined in paragraphs 3.39 and 3.40 below).
- 2.2. We consider that the principal benefit of continuing to provide uninsurability protection is that future OFTOs need not price the full risk of uninsurable latent defects into their bids. It would not be good value for money for consumers if all OFTOs created contingent provisions to fund uninsurable cable failures caused by latent defects, considering it is unlikely that the risk will crystallise in all projects. A secondary benefit of continuing to provide such protection is that it makes OFTOs more resilient to risks that, through no fault of their own, they can neither forecast nor mitigate, thereby reducing the long-term risk of OFTOs ceasing to provide transmission services.
- 2.3. We are retaining the requirement (as is currently set out in our invitation to tender documents (**ITT**) from tender round five onwards) that OFTOs must have, as a minimum, an Operational All Risk insurance policy with a LEG3/06<sup>13</sup> exclusion or equivalent which includes insurance protection for all cable repair costs.
- 2.4. We set out a definition for 'uninsurable' in relation to our policy on the IAE Condition; this is based on the PF2<sup>14</sup> definition of 'uninsurable', tailored to impose a high bar on OFTOs to prove that a risk is in fact uninsurable. The burden of proof is on the OFTO. We discuss uninsurability protection in paragraphs 3.1 to 3.42.

### Policy positions

- 2.5. Other specific conclusions we have drawn are:
  - I. We intend to apply a deductible to all successful IAE claims in respect of an uninsurable latent defect (an **Uninsurable IAE Claim**). In relation to existing

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<sup>12</sup> <https://www.ofgem.gov.uk/publications-and-updates/open-letter-consultation-income-adjusting-event-policy-offshore-transmission-licences-0>

<sup>13</sup> London Engineering Group 3. A LEG3 exclusion, excludes the 'improvement consequences' of a defect. The London Engineering Group Model 'Improvement Consequences' Defects Wording for the LEG3/06 exclusion is as follows:

"The Insurer(s) shall not be liable for: All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.[...]"

<sup>14</sup> <https://www.gov.uk/government/publications/private-finance-2-pf2>

OFTOs, we intend to set the deductible as the same amount as the insurance deductible set out in each OFTO's bid. In relation to future OFTOs, we intend to set the deductible at £5m or the insurance deductible set out in the OFTO's bid, whichever amount is higher. We discuss this at paragraphs 3.43 to 3.63.

- II. We intend to amend Paragraph 15(a) of the IAE Condition to remove reference to the System Operator Transmission Owner Code (**STC**) and insert a definition of force majeure that:
- (a) excludes reference to the fault of plant and apparatus; and
  - (b) removes the requirement not to be able to perform an obligation under the STC from the Offshore Transmission Owner Licence (**OFTO Licence**).

We discuss this at paragraphs 3.73 to 3.80.

- III. We intend to introduce two new bands of IAE thresholds to ensure that the threshold amount contained in the IAE Condition is appropriately linked to the transfer value of OFTO assets. We discuss this at paragraphs 3.81 to 3.84.

- 2.6. The three policy positions listed above would be implemented by modifications to the OFTO Licence and will therefore be subject to a further statutory consultation process in accordance with the Electricity Act 1989. For simplicity and throughout the remainder of this document, we refer to these policy positions as 'policy positions' or 'decisions' interchangeably. We will consider all responses to the statutory consultation in reaching our final decision, as we have done to date with the IAE Open Letter in reaching our policy positions.

## Clarification

- 2.7. We emphasise that, while Ofgem does not have the statutory powers to place obligations on offshore developers to provide extended warranties, we strongly encourage developers to provide warranties that cover all costs associated with asset repair for a minimum of 5 years from the date the offshore transmission assets are transferred to the OFTO. This is discussed at paragraphs 3.64 to 3.72.

### 3. Policy applicable to the IAE Condition

- 3.1. This section explains the rationale behind our policy positions, including our policy intent and how we consider that will be achieved. It discusses the 19 responses received to the Open Letter published on 6 February 2018 (the **IAE Open Letter**)<sup>15</sup> and the information obtained from our discussions with industry participants in relation to each element of the policy proposal contained in the IAE Open Letter.
- 3.2. We consider the form of uninsurability protection, as set out below, will continue to ensure that paragraphs 14 to 24 of Amended Standard Condition E12-J3 (the **IAE Condition**) operates in the best interests of consumers.
- 3.3. The proposed balance of risk will ensure that future Offshore Transmission Owner (**OFTOs**) need not price the full risk of uninsurable latent defects into their bids. We consider the proposed level of protection is sufficient to make OFTOs more resilient to risks that, through no fault of their own, they can neither forecast nor mitigate, thereby reducing the long-term risk of OFTOs ceasing to provide transmission services.
- 3.4. The IAE Condition will not provide protection where the OFTO has caused the relevant risk to be uninsurable or has merely chosen not to put appropriate commercial arrangements in place to manage the risk.

### Defining uninsurability

- 3.5. As proposed in the IAE Open Letter, the IAE Condition will continue to provide uninsurability protection where the OFTO is unable effectively to mitigate the effects of latent defect risk (including, through no fault of its own, that risk becoming Uninsurable as defined in paragraphs 3.39 and 3.40 below).

#### *Responses received*

- 3.6. The majority of respondents provided comments on the application of the concept of uninsurability in the context of the IAE Condition. Some responses supported the policy proposed in the IAE Open Letter and some responses did not. We discuss the key issues addressed in the responses below.

#### *Protection for uninsurability*

- 3.7. Seven respondents supported our proposal that the IAE Condition should continue to provide protection for latent defects in relation to uninsurable OFTO assets. These respondents set out their understanding that OFTOs would not be subject to construction risk that was not covered by warranties and/or insurance. One respondent went on to note that "*OFTOs are incentivised to undertake due diligence*

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<sup>15</sup> <https://www.ofgem.gov.uk/publications-and-updates/open-letter-consultation-income-adjusting-event-policy-offshore-transmission-licences-0>

*and failure to do so risks insurance protection; in addition, OFTOs must bear any insurance deductibles”.*

- 3.8. The overarching premise of the offshore regime, in relation to the generator build model, is that the developer bears the risks associated with the construction of the transmission assets. In contrast, the OFTO is responsible for owning and operating the transmission assets from the point of asset transfer, and for the associated risks arising from ownership of the assets. The offshore regime was not designed to insulate OFTOs from all risks, such as a latent defect, that could be traced back to the construction of the assets. However, we consider the IAE Condition should operate to provide uninsurability protection that puts the claimant OFTO back in the position it would have been in had the risk of damage caused by a latent defect been insurable. In this context, we consider that applying a deductible to all successful IAE claims in respect of an uninsurable latent defect (**Uninsurable IAE Claims**) is sensible because:
- it is consistent with an insurance response
  - it meets our policy objective, to ensure the offshore transmission licence (**OFTO Licence**) responds in the most appropriate way in order to protect the interests of consumers when the risk associated with OFTO assets becomes uninsurable, and
  - it incentivises OFTOs to manage risk by ensuring they have appropriate commercial arrangements in place where possible.
- 3.9. See paragraphs 3.43 to 3.63 for further discussion on applying a deductible to Uninsurable IAE Claims.

#### *Impact on protections*

- 3.10. Four respondents stated that the approach proposed in the IAE Open Letter could reduce the protections OFTOs have today, as they understood that the IAE Condition would “*protect against the impact of risks that the OFTO could not have foreseen through appropriate due diligence*”.
- 3.11. We do not agree that our approach will reduce the protections OFTOs have today. It is clear from our discussions with interested parties and the responses to the IAE Open Letter that there were a wide range of views about how the IAE Condition would respond to uninsurability and subsea cable failures prior to the GyM SSEC2 decision. Our policy position provides certainty that the IAE Condition will continue to provide uninsurability protection where the OFTO is unable effectively to mitigate the effects of latent defect risk (including, through no fault of its own, that risk becoming Uninsurable as defined in paragraphs 3.39 and 3.40 below).
- 3.12. We have discussed our approach to providing uninsurability protection with various financial agencies, who have advised that certainty in how the IAE Condition will respond in such circumstances is helpful in relation to their assessment of the risks of the offshore regime. It is our view that our policy position provides increased certainty to the market by making clear how we will respond when certain risks are uninsurable, and by defining ‘uninsurable’ to avoid doubt. This improves the stability and robustness of the offshore regime.
- 3.13. Further, we consider our policy places a claimant OFTO in the position it would have been in had it taken out comprehensive insurance cover and its insurance remained in place. OFTOs structure themselves with a cash account or liquidity facility to help

fund the cost of insurance deductibles should they be required to claim under their insurance policy. It follows that it is appropriate that OFTOs should be required to draw from these sources for events that would otherwise have been expected to be covered by insurance.

#### *Consistency with IAE decisions*

- 3.14. Seven respondents raised concerns that the approach proposed in the IAE Open Letter contradicted the statements we have made in previous IAE decisions.<sup>16</sup> A key concern was our statement that: *“An OFTO licensee should enter into the transaction of acquiring OFTO assets with the awareness that it is assuming any risks arising from damage or defects that it has not been able to discover through its due diligence. The offshore regime was not designed to insulate OFTOs from all such risks.”*
- 3.15. We consider that our policy is consistent with what we have said before and does not contradict our previous statements. A latent defect is a type of risk that is reasonably foreseeable and OFTOs should put in place appropriate commercial arrangements to manage or absorb such risks. In this context, we will continue to apply the four factors set out in paragraph 1.6 when assessing whether an event constitutes an IAE under limb (c) of Paragraph 15 of the IAE Condition (**Paragraph 15(c)**).
- 3.16. Our policy puts the OFTO back in the position it would have been in had the risk of damage caused by a latent defect been insurable. It does not guarantee the success of an Income Adjusting Event (**IAE**) claim. The OFTO must demonstrate that it had sought to put in place appropriate commercial arrangements to manage the foreseeable risk of latent defects and that it has properly pursued all relevant claims against third parties.

#### *OFTO risk*

- 3.17. More generally, a number of respondents considered that the party responsible for the assets should bear the risk of damage or defects. In particular, two respondents considered that the policy, as proposed in the IAE Open Letter, insulated the OFTO from all risks whilst placing responsibility onto generators. One respondent noted that OFTOs already price insurance into their bids and any inadequacy in insurance should be attributable to the OFTO alone. One respondent noted that, in other regimes, it is the asset owner that takes on risk associated with underperformance. One respondent was of the view that the IAE policy only strengthened the position of the OFTO.
- 3.18. We do not agree with respondents’ views that our policy insulates OFTOs from all risks. It only insulates OFTOs to the extent that the IAE Condition will provide uninsurability protection where the OFTO is unable effectively to mitigate the effects of latent defect risk (including, through no fault of its own, that risk becoming Uninsurable as defined in paragraphs 3.39 and 3.40 below). These circumstances are limited. Furthermore, the IAE Condition will not provide protection where an OFTO has caused the relevant risk to be uninsurable. Our view is that the risk should sit with the OFTO when it can most appropriately manage the risk, which is why we

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<sup>16</sup> See footnotes 4, 5, 6 and 7 for links to our previous decisions.

strongly encourage developers to provide OFTOs with warranties that are sufficient to cover such failures. Developers are also best placed to assure the quality of the construction and installation of the transmission assets and the design and type of cable. Notably, the causes that have been attributed to subsea cable failures in GB to date are errors in the design, manufacturing and/or installation of the cables.

#### *Multiple failure events*

- 3.19. The IAE open letter stated that *“We consider that a policy approach along the lines discussed above will have the practical effect that limb (c) of the IAE Condition will, apart from exceptional circumstances, never cover the first event of asset failure (on the basis that any such event would be properly insurable)”*.
- 3.20. A number of respondents asked that we define ‘first failure’ and what we mean by ‘exceptional circumstances’. One respondent considered that second failure events should not automatically be considered as IAEs. One respondent considered that *“insurers would expect OFTOs to pursue warranty providers before considering paying out, and so we would expect Ofgem to do the same where insurance is believed unavailable otherwise this shifts risk allocation further onto developers/owners where insurers are not involved.”*
- 3.21. All IAE claims made under Paragraph 15(c), including one relating to a first failure event, will be assessed against the four factors set out in paragraph 1.6 above. The onus is on the OFTO to provide sufficient evidence to demonstrate to the Authority that the first failure, or any subsequent event, constitutes an IAE. This will include evidence that the claimant has exhausted all avenues of commercial recourse. We continue to expect that the first failure event will ordinarily be protected by insurance, warranties and/or other commercial recourse and is therefore unlikely to result in an IAE claim. This is consistent with our view that developers should provide warranties that cover all costs associated with asset repair for a minimum of 5 years from the date the offshore transmission assets are transferred to the OFTO.

#### *Insurer behaviour*

- 3.22. One respondent considered that the policy, as proposed in the IAE Open Letter, would affect insurer behaviour and result in insurers removing protection for all latent defects. It considered that Ofgem’s interference in the market is not advisable and that Ofgem should monitor whether any changes drive efficient behaviours. Three respondents considered that this proposal could lead to OFTOs being disincentivised to seek appropriate insurance, and may weaken incentives on insurers to provide insurance. Another respondent considered that there are several risks associated with the policy, as proposed in the IAE Open Letter, including that:
- insurers will not insure any assets they consider high risk because they will consider that these assets can be covered by Ofgem’s IAE policy
  - OFTOs will procure insurance but at excessive costs due to the imposed requirements, and try to pass these costs through to their Tender Revenue Stream, and
  - OFTOs may procure insurance, but not at sufficient or efficient levels to protect the bearer of the cost of the IAE.

3.23. We discussed the policy proposal as set out in the IAE Open Letter with two insurers and two insurance advisers/brokers that are active in the OFTO insurance market in order to gauge the impact the policy proposal may have on the OFTO insurance market. As a result of our discussions, we are satisfied that our policy position will not have an adverse impact on insurer behaviour.

3.24. Our view in response to these concerns is that:

- Whether insurers are willing to insure particular assets is a commercial decision for them. Insurers have their own basis for deciding whether insurance will be offered in relation to particular assets. Our policy position makes clear to all stakeholders under which circumstances the IAE Condition will provide uninsurability protection.
- One reason they choose to stay in the OFTO market is that the insurers insure generator assets and the insurers find it beneficial to have visibility of associated OFTO transmission assets.
- OFTOs are in a competitive bidding environment. It is not advantageous for OFTOs to procure insurance at an excessive cost on the basis that they will pass the cost through their Tender Revenue Stream because they are competing on price with other bidders.
- We have stipulated a minimum level of insurance cover that we require OFTOs to obtain (as set out in the invitation to tender (**ITT**) documents) in order to mitigate the risk that OFTOs could procure insurance that does not sufficiently protect against failure events. This is also a requirement under the Crown Estate Lease. In addition, under our policy position, OFTOs will have to satisfy Ofgem that they have taken reasonable steps to obtain and/or maintain sufficient insurance cover if the initial level of cover is inadequate or has been downgraded by an insurer.

#### *Definition*

3.25. The level of uninsurability and the level of insurance procured by OFTOs were of considerable interest to respondents. Eleven respondents considered that OFTOs should be incentivised to take out insurance with a LEG 3 exclusion. Four proposed that the OFTO Licence define the term 'LEG3' to ensure consistency amongst OFTOs. Two considered that IAEs should not be available to OFTOs with less than comprehensive LEG3 cover. One respondent noted that it is still possible for unaffected OFTOs to secure LEG3 insurance. One respondent questioned whether the protections that we expect developers to offer to OFTOs are necessary if OFTOs were required to take out LEG3 insurance cover. One respondent asked that the reference to "the worldwide market" in the definition of uninsurability be amended to reference "the relevant insurance market ...".

3.26. As proposed in the IAE Open Letter, we have drafted a definition for the term 'uninsurable', which we set out below at paragraphs 3.39 to 3.41. Two independent insurance experts reviewed the definition to ensure the language is consistent with the OFTO insurance market. We consider that the definition provides certainty as to the scope and meaning of uninsurability in the context of Uninsurable IAE Claims.

3.27. As discussed at paragraph 2.3 above, we have prescribed the level of operational all risk insurance cover that we expect OFTOs to have in place under the tender process, which is consistent with the level of insurance stipulated under the Crown

Estate Lease. In particular, from tender round five onwards, we specify in the ITT documents that bidders are required to have in place as a minimum an Operational All Risk insurance policy with a LEG3 exclusion or equivalent, which includes insurance protection for all cable repair costs. In other words, an insurance policy that covers the full cost of replacement or rectification of the insured assets rendered necessary by the defect. This requirement in the ITT will be updated for new projects to reflect the definition of Insurance set out below at paragraph 3.39 for consistency. We consider that our definition of uninsurable is sufficiently detailed to ensure comprehensive insurance cover is now taken from the outset. IAE claims will be assessed against the initial procurement of and subsequent availability of this level of insurance.

#### *Application to all offshore transmission assets*

- 3.28. Three respondents sought clarity on whether the policy we have applied to Paragraph 15(c) related to all assets or just subsea cables. One respondent specifically asked Ofgem to “clarify that any precedents set for a specific cable failure do not necessarily apply to future cable issues (which may have entirely different root causes), or issues with any other elements of offshore assets.”
- 3.29. The IAE Condition is not limited to a specific type of transmission asset and although all IAE claims to date have concerned subsea cables we cannot predict what issues may arise with different parts of an offshore transmission system in the future. Uninsurability protection will therefore apply for damage to any part of the offshore transmission assets, not just export cables, which is caused by a latent defect. However, uninsurability protection is specifically limited to circumstances where the OFTO is unable effectively to mitigate the effects of latent defect risk (including, through no fault of its own, that risk becoming Uninsurable as defined in paragraphs 3.39 and 3.40 below).

#### *OFTO incentives*

- 3.30. One respondent considered that the policy, as proposed in the IAE Open Letter, is likely to ‘incentivise OFTOs to rely on time-consuming regulated outcomes to problems, which lead to: potential delays in expediting and mobilizing a repair; increased asset downtime; higher financial penalties for generators and other shareholders of the generation assets; and inefficient outcomes for consumers.’
- 3.31. We consider that there are sufficient obligations in the OFTO Licence to ensure OFTOs maintain their transmission assets and respond promptly to any required repair. Failure to comply with its licence obligations could result in enforcement action under section 25 of the Electricity Act 1989. An OFTO’s funding agreement will also generally require that OFTOs fully comply with the law, including all OFTO Licence requirements. As a further OFTO incentive, we have concluded that a deductible should be imposed on all Uninsurable IAE Claims (see paragraphs 3.43 to 3.63 for more information on deductibles).
- 3.32. We are also confident that the market is responding appropriately, to minimise the impact of major failure events on all parties concerned. In our assessment of an OFTO’s ability to respond to a major failure event during recent tender processes, we have observed significant developments in the preparedness of OFTOs to promptly respond to such events. For example, it is now common practice for OFTOs to enter into framework agreements with contractors to provide emergency repairs of their transmission assets, including the availability of offshore vessels. Insurers have also



responded with strategies to both minimise the occurrence of major failure events and ensure when they do occur that they are rectified in the shortest possible time. We are aware of work by a leading insurer, in conjunction with an OFTO and generator, to streamline the repair process in order to significantly reduce the total outage time. This is in addition to the preventative measures now being imposed by the insurers on insured offshore transmission assets such as the supervision of all handling of the transmission cable prior to and during installation.

- 3.33. Further, we calculate the cost of the IAE claim on an 'economic and efficient' basis; in other words, we take into account the actions of the OFTO and assess whether an efficient OFTO, in the position of the claimant OFTO, would have acted more efficiently and/or economically resulting in lower cost repairs. In addition, Exceptional Event claims, which seek an adjustment to the value of the OFTO's monthly capacity weighted unavailability to offset the impact of a failure event, are assessed on the basis of whether reasonable steps consistent with Good Industry Practice have been taken. The OFTO's availability will be directly penalised for any inefficiencies in repairing the assets, which the Authority has done in relation to two Exceptional Event claims to date.

#### *Future Issues Criteria for applying limb (c)*

- 3.34. Four respondents noted that changes to the IAE Condition must reflect past experience and be fit for purpose in the future. Future issues may include significant downward pressure on construction costs; future changes to latent defect insurance cover (from the current LEG3 cover); changes to commercial recourse available to OFTOs in the future; and changing windfarm outputs or transmission requirements causing unexpected asset damage. Those respondents went on to say that "*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.*"
- 3.35. We acknowledge the competitive environment in which developers are operating and the pressure to reduce construction costs. However, we think our approach is the best balance between upfront cost to developers and long-term risk to the consumer.

#### *Definition of uninsurable*

- 3.36. We have defined the term 'uninsurable' in a similar way to the definition used in public private partnership (**PPP**) projects for contracting authorities and have taken into account the views of respondents and offshore insurance brokers in drafting the definition set out below. The definition is also based on the definition of 'uninsurable' set out in the HM Treasury guidance on PF2 contracts.<sup>17</sup>
- 3.37. A number of respondents stated that the definition of uninsurability must be clear and robust and that OFTOs must provide robust evidence that insurance has been withdrawn. The definition set out below sets a high bar that OFTOs must meet. OFTOs will be required to provide evidence to satisfy the Authority about the status

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<sup>17</sup> See e.g. HM Treasury guidance on Standardisation of PF2 contracts, Chapter 17 (Insurance): [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/207383/infrastructure\\_standardisation\\_of\\_contracts\\_051212.PDF](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207383/infrastructure_standardisation_of_contracts_051212.PDF)

of their insurance cover including proof of annual attempts to procure comprehensive insurance within the Worldwide Offshore Transmission Asset Insurance Market.

3.38. When assessing an IAE claim and the ability of the claimant OFTO (referred to as the licensee in the definition of 'Uninsurable') to manage the risk or impact through risk management arrangements we will apply the following definition of 'uninsurable'.

3.39. **Uninsurable** means, in relation to a Risk, either that:

(a) Insurance is not available to the licensee in respect of all or part of its Transmission Assets in the Worldwide Offshore Transmission Asset Insurance Market with reputable insurers of good standing in respect of that Risk, as determined by the Authority, or

(b) the Authority determines in its absolute discretion, that the insurance premium payable for insuring that Risk is at such a level that the Risk is deemed as not being insured against in the Worldwide Offshore Transmission Asset Insurance Market with reputable insurers of good standing by a licensee(s).

3.40. For the purpose of the definition of 'Uninsurable':

- A **Risk** is the physical loss or damage requiring replacement or rectification of Transmission Assets, which is caused by a latent defect resulting from material workmanship design plan or specification.
- A '**latent defect**' means (i) a flaw in Offshore Transmission Assets, which is an actual defect in material workmanship design plan or specification, not the damage resulting from the defect; and (ii) which existed but which would not have been apparent to an efficient licensee in the position of the licensee at the time the Offshore Transmission Assets were transferred to it.
- **Insurance** means the indemnity which would normally be covered by an Operational All Risk insurance policy with a LEG 3/06 exclusion<sup>18</sup>, or equivalent, which includes indemnity for the full cost of replacement or rectification of the Offshore Transmission Assets (but not improvement) rendered necessary by damage which is the consequence of a latent defect.
- Reference to the **Worldwide Offshore Transmission Asset Insurance Market** means all insurers who, after an exhaustive search, would reasonably be understood by an efficient licensee, in the position of the Licensee, to be participating in the business of insuring offshore transmission assets (to be determined by the Authority in its absolute discretion).

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<sup>18</sup> London Engineering Group 3. A LEG3 exclusion, excludes the 'improvement consequences' of a defect. The London Engineering Group Model 'Improvement Consequences' Defects Wording for the LEG3/06 exclusion is as follows:

"The Insurer(s) shall not be liable for: All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.[...]"

- **Offshore Transmission Asset/s** means the transmission system to which the licensee’s Offshore Transmission Owner Licence relates as set out in Annex B to amended standard condition E12–B1 (Transmission System Area) in the licensee’s Offshore Transmission Owner Licence.

3.41. In the event that all or part of an OFTO's offshore transmission system becomes uninsurable (as per the definition above), we will expect OFTOs to approach the Worldwide Offshore Transmission Asset Insurance Market (as defined above) on a (minimum) yearly basis to determine whether the risk has become insurable again. We consider this a reasonable timescale on the basis that the majority of OFTO insurance policies are renewed on a yearly basis.

*Generator Build Tender Exercise*

3.42. For clarity, our decision to continue to provide protection for latent defects in relation to uninsurable OFTO assets applies where the offshore transmission assets have been subject to a generator build tender exercise.<sup>19</sup>

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<sup>19</sup> ‘Generator build tender exercise’ is defined in Regulation 3 of The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 (published on our website [www.ofgem.gov.uk](http://www.ofgem.gov.uk)).

## Application of deductible to Uninsurable IAE Claims

- 3.43. Under HM Treasury guidance on PF2 contracts, any uninsurability payment to contractors is paid net of the insurance deductible. Likewise, in the IAE Open Letter, we proposed setting a deductible of £5m or 30% of the claim, whichever is higher, to all Uninsurable IAE Claims. We considered that imposing a deductible was appropriate, because it best places the OFTO into the position they would have been in had the event been insurable. The level of the deductible was proposed on the basis that it was reasonable for OFTOs to contribute to a sizeable share of the cost of repair for Uninsurable IAE Claims.
- 3.44. A number of respondents agreed that a deductible should be applied to IAE costs but had differing views as to the level at which the deductible should be set. One respondent did not support this proposal and stated that the imposition of a deductible may result in OFTOs being exposed to an unlimited number of deductibles for repeat failures resulting from a latent defect, which OFTOs could not sustain.
- 3.45. Twelve respondents considered that there was no justification for the deductible to be set at £5m or 30% of the claim, whichever is higher. A deductible of this size changes the financial profiling of existing OFTOs. Respondents also argued that a deductible of this size would be disproportionate to the size of some of the tender round one OFTOs, with £5m being greater than the annual revenue determined by the tender revenue stream value for some projects. The sum was therefore not sustainable. Similarly, four respondents were of the view that OFTO financing structures are not designed to accept an unlimited number of deductibles and an increase from £1m to £5m would make OFTOs less resilient to enduring major failure events.
- 3.46. One respondent stated that it is not economic or efficient for an OFTO to include contingency costs for a risk that may not be realised in its tender bids. This would not constitute value for money and therefore would not be in consumers' interests. Four respondents proposed that the deductible should be set at the amount of the OFTO's most recent insurance deductible, obtained by the OFTO in the period that the costs were incurred or the period in which the risk became uninsurable, or at the level of the IAE Threshold.
- 3.47. Conversely, two respondents stated that they would not be satisfied if the deductible was less than 30% of the claim, whilst another asked that Ofgem bear in mind the value of the OFTO asset when setting the deductible.
- 3.48. We have considered the responses received and taken them into account in making our assessment of whether to impose a deductible on Uninsurable IAE Claims. We want to ensure that the deductible is set at a level that incentivises OFTOs to obtain and retain Operational All Risk insurance with a LEG 3 exclusion, or equivalent, in order to minimise the number of IAE claims and be in consumers' interests.
- 3.49. We have also conducted internal analysis on the impact on differing OFTOs, bearing different size deductibles. This has led us to conclude that a deductible that is in line with what is proposed is sufficient to ensure that OFTOs bear some IAE costs, without unduly affecting their financial models. We have also looked closely at the results of two current tenders that have been instructed to assume that a deductible will apply and the financial profiling of existing OFTOs, which are discussed further below.

- 3.50. We have concluded that a deductible should be imposed on all Uninsurable IAE Claims. We consider that this will ensure that the IAE Condition will not operate to provide 'windfall' benefits as compared to an insurance pay-out, thus incentivising OFTOs to obtain and keep insurance wherever practicable (NB OFTOs must provide evidence that insurance has been withdrawn).
- 3.51. However, we consider that the level of the deductible should be different for existing and future OFTOs. The reasons for this and the meaning of 'existing' and 'future' OFTOs are discussed below.

*Existing OFTOs<sup>20</sup>*

- 3.52. 'Existing OFTOs' means all OFTOs that currently hold an OFTO Licence. See reasoning in paragraph 3.56 below.
- 3.53. We agree with respondents that imposing a higher IAE deductible than that set in an existing OFTO's insurance policy at the time of licence grant could change the OFTO's risk profile because the OFTO may not have sufficient cash reserves to cover the IAE deductible. There is a range in the level of insurance deductibles for existing OFTOs, with the majority of early projects having a deductible of between £250,000 - £500,000 and the more recent projects in the order of £2.5m - £5m. The change partly reflects an increase in the size of the projects but is also a reflection on the cost of insurance as a critical element in the tightening competition within the offshore tender regime.
- 3.54. OFTOs are project-financed entities structured in such a way that, for the majority of existing OFTOs, any requirement to meet a deductible greater than that accounted for in their financial models at financial close, would mean there is a significant shortfall in available finances to meet a proposed £5m deductible. The existing OFTOs' capacity to meet any shortfall is also questionable where the majority of existing OFTOs have an annual tender revenue stream of between £4m and £10m or less.
- 3.55. After considering the level of deductible proposed and the size and funding arrangements of existing OFTOs, we have concluded that the policy proposed in the IAE Open Letter is not preferable for Existing OFTOs. We have therefore decided that the IAE deductible for existing OFTOs should be set at the level of the insurance deductible set out in each OFTO's ITT bid. This is a figure known by the Authority for each OFTO and which the OFTO has factored into its financial modelling. We consider this will not result in a change to the OFTO's risk profile and will provide existing OFTOs with certainty about the IAE deductible that will be applied to Uninsurable IAE Claims. We intend to implement our policy position for Existing OFTOs by modifying the OFTO Licence, under section 11A of the Electricity Act 1989. Accordingly, we will run a statutory consultation on the proposed OFTO Licence modification in due course (see Section 5 for more information).

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<sup>20</sup> The terms 'Bidder', 'Preferred Bidder' and 'Reserve Bidder', 'Withdraw' and 'Invitation to Tender' are defined in Regulation 3 of The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 published on our website [www.ofgem.gov.uk](http://www.ofgem.gov.uk).

### *Future OFTOs<sup>21</sup>*

- 3.56. 'Future OFTO' means any OFTOs licenced after the date of this publication. Future OFTOs were instructed under the relevant tender process to assume that a deductible of £5m or 30% of the claim (whichever is higher) will be imposed on Uninsurable IAE Claims.
- 3.57. We have reviewed the bids submitted by parties who wish to own and operate the transmission links to the Race Bank and Galloper offshore wind farms. In line with the uninsurability assumptions instructed, all bidders bar one have increased their insurance deductibles to £5m or greater. The decision for one bidder to set the insurance deductible higher than the £5m proposed was unexpected. This high deductible presented the proposition that an OFTO could be in a better position under an Uninsurable IAE Claim than if it could claim for a major failure event under its insurance policy.
- 3.58. In addition, upcoming tender round five and six projects are all substantially higher in value, and based on recent trends it seems likely that insurance deductibles for new projects will be set at £5m or higher.
- 3.59. Future OFTOs are also in a position to incorporate the stated deductible into their financial model and set their emergency reserve accounts and financial response strategies accordingly.
- 3.60. Taking the above information into account, for Future OFTOs, we intend to set the IAE deductible at £5m or the level of the insurance deductible set out in the OFTO's ITT bid, whichever is higher. In light of respondents' views and for the reasons set out above, this policy departs from the approach consulted on in the IAE Open Letter, that the IAE deductible would be £5m or 30% of the value of the claim, whichever is higher. We consider that it would not be appropriate for an OFTO to be in a better financial position from a successful Uninsurable IAE Claim than it would have been under its insurance policy. This goes beyond the objective of stepping into the shoes of an insurer and would not be in consumers' interests. We consider that this policy does not appear to have any real impact on cost of capital or tender revenue stream to transfer value ratios.
- 3.61. We intend to implement our policy position for Future OFTOs by modifying the OFTO Licence, under section 8A of the Electricity Act 1989. Accordingly, we will run a statutory consultation on the proposed OFTO Licence modification in due course (see Section 5 for more information).

### *Total IAE award*

- 3.62. Four respondents agreed that any IAE costs awarded should be capped at reinstatement costs. No respondents made comments on the fact that IAE claims are paid net of all commercial avenues of recourse.

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<sup>21</sup> The terms 'Bidder', 'Developer' 'Preferred Bidder' 'Reserve Bidder', 'Withdraw' and 'Invitation to Tender' are defined in The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 published on our website [www.ofgem.gov.uk](http://www.ofgem.gov.uk)

3.63. The IAE Condition provides that the Authority determine a revenue adjustment for a successful IAE claim that ensures the financial position and performance of the OFTO are, in so far as is reasonably practicable, the same as if the IAE had not occurred. Thus, all costs claimed must be a direct result of the IAE and will be paid net of all sums recovered through commercial avenues of recourse. We will continue to determine the quantum of a successful IAE claim on this basis; however, the total revenue adjustment, for Uninsurable IAE Claims, will be less the relevant deductible.

## Protections to be offered by Developers

3.64. In the IAE Open Letter, we set out contractual protections that we expect developers should offer to OFTOs as a minimum at the time of asset transfer, including:

- five-year warranties (commencing at handover of completed assets to the developer) for all costs of repair and replacement of sub-sea cables procured by the offshore wind generator from its contractors;
- a cumulative minimum liability cap of 10% of the estimated transfer value of the offshore transmission assets; or
- contractual protection to the OFTO to 'top up' the existing contractor warranties that will be transferred, in order to give the OFTO an overall contractual protection that is equivalent to the above.

3.65. A number of respondents agreed that developers should provide minimum protections but had differing views as to what these should be. Some respondents proposed warranties as long as 10 or 12 years or stated that 10% of estimated transfer value or 15% of the relevant contract values were suitable levels.

3.66. Of those that agreed with the proposed protections:

- Seven respondents stated that the warranty should be longer than 5 years, with three of these respondents proposing warranties as long as 10 years, on the basis that *"this is standard for submarine cables"* and that the warranty should commence at asset transfer or after the 'take over certificate' has been issued. Four respondents noted that *"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."*
- Four respondents noted that OFTOs have limited opportunity to carry out due diligence and must accept the warranties offered by the generator. They went on to say that *"it is impossible for OFTO bidders to negotiate sensible latent defect warranties with generators"*.
- Four respondents considered that OFTOs would bear a significant burden if a latent defect arises after 5 years. They considered that OFTOs should be insulated from risk associated with known latent defects that have arisen at the outset or that have arisen on another offshore transmission system (*"where the features of an offshore cable have led to more than one offshore cable failure"* but not latent defects arising well after the transfer of the ownership of the transmission assets").
- One respondent asked that it be made clear that where the IAE Open Letter refers to 'contractors' in the context of generators procuring 5 year warranties for

all costs of repair and replacement of sub-sea cables from its contractors, *"it refers to the cable manufacturer and the cable installation contractor; where it has seen liabilities capped as low as 25% of the contract value."*

- One respondent considered that 10% of estimated transfer value or 15% of the relevant contract values were suitable levels. One respondent noted that, although supportive of the 10% cap on the transfer value, contractors will normally limit liability to 100% of the contract value.
- Four respondents noted that repair costs could exceed 10% of the asset transfer value; they noted that under the PF2 regime a *"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."*
- One respondent noted that parent company guarantees were difficult to enforce and protection should be via letter of credit or performance bonds.
- One respondent considered that the subsea cable warranty should explicitly cover 'vessel costs'. Five respondents stated that the developer should extend the warranty where more than one event occurs, due to the same root cause.
- A number of respondents asked that we clarify the meaning of 'estimated transfer value'. The estimated transfer value is Ofgem's estimate of the economic and efficient costs that the project developer ought to incur when developing and constructing the offshore transmission system, often known as the Indicative Transfer Value, which is included in the ITT for each project.

3.67. Six respondents disagreed with the proposed protections. Of those that disagreed:

- Five respondents considered that Ofgem should not require developers to offer minimum protections and stated that this is a commercial matter between OFTOs and developers. One respondent went on to say that *"This is backdoor regulation of the development and construction of offshore wind farms; a well-functioning competitive market which lies outside of Ofgem's remit."*
- One respondent noted that developers would seek insurance to cover any indemnity, leading to increased costs and potentially double insurance where an OFTO is insuring for the same assets.
- Three respondents were concerned that developers would meet the gap between the warranty and the proposed 10% indemnity and the offshore generator could still be liable for repeat repair costs after 5 years.
- Three respondents asked Ofgem to clarify why the current warranties are insufficient.
- Three respondents noted the difficulty with securing extended warranties, for separate cable laying contracts, as cable manufacturing and laying is complicated and requires separate and different contracts for different stages.
- One respondent sought clarity as to when an OFTO would rely on LEG3 insurance as opposed to the proposed warranty or indemnity.
- Two respondents sought clarity on whether developer warranties only need to cover latent defects and not third party damage, wear and tear etc.



- Four respondents considered that offshore generators are already incentivised to build fit for purpose offshore transmission assets, as the generator bears the cost of lost revenue for any outages.

*Ofgem's policy*

- 3.68. We note the view of a number of respondents that Ofgem should not interfere in commercial matters between OFTOs and developers. The IAE Open Letter stated that we expect, rather than require, developers to put the aforementioned minimum protections in place. We recognise that Ofgem does not have the statutory powers to place obligations on offshore developers to provide extended warranties. However, we continue to be of the view that it is in the best interests of the developer, OFTO and consumer for developers to obtain sufficient commercial protection to address latent defect issues. As noted in the IAE Open Letter, a large proportion of any IAE costs awarded will be passed through to the relevant offshore developer; this is a further incentive for developers to build fit for purpose assets and provide the necessary warranties.
- 3.69. Three of the four IAE claims to date involved subsea cable failures that occurred shortly after asset transfer. However, the cable warranties transferred by the developers were not sufficient to cover the cost of the repair. This can be contrasted with a subsea cable failure experienced by another OFTO that had a fully comprehensive cable warranty from the manufacturer novated at asset transfer. In that case, the OFTO did not make an IAE claim because the full cost of repair was covered by the warranty.
- 3.70. There is currently a large variation in the duration and scope of warranties procured by developers and novated to OFTOs at asset transfer. We consider longer, comprehensive warranties that include vessel costs will minimise the number of IAE claims, as the OFTOs would rely on the warranty for protection for costs as a result of a latent defect. This in turn will enhance the longer term viability of the OFTOs and hence the continuous operation of the offshore transmission system.
- 3.71. Leading insurers have also advised us that the availability of commercial protections are a key factor in determining whether to comprehensively insure offshore transmission assets. We appreciate the concerns of double costs in this regard but note that this is currently the status quo for a number of projects and consider the protections will ultimately minimise the number of events which are determined to be IAEs. Insurers also fill a vital role in ensuring sufficient cash flow is available to OFTOs to carry out an efficient repair. As such, we strongly encourage developers to provide warranties that cover all costs associated with asset repair for a minimum of 5 years from the date the offshore transmission assets are transferred to the OFTO. We recognise that the costs of doing so where contracts have already been let may be prohibitive but for future contracts we consider this should be standard practice.
- 3.72. If longer warranties are in place, it is more likely that IAEs can be avoided which in turn means that costs will not flow to the developers. Additionally the availability of warranties assists with the retention of insurance in the OFTO market, which is a key component of an efficient repair process with the provision of liquidity.

## **Modification of limb (a) of Paragraph 15**

- 3.73. It has been suggested that the current drafting of sub-paragraph 15(a) of the IAE Condition (**Limb (a)**) results in some legal uncertainty. Limb (a) uses the definition

of force majeure under the System Operator Transmission Owner Code (the **STC**). One respondent considered that this definition is not appropriate in the context of IAE claims by virtue of the requirement that there be a “*failure*” by a party “*to perform any of its obligations*” under the STC. There is also said to be uncertainty, arising from reference in the STC’s definition to “*fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice)*”, as to the proper application of that test to the IAE context.

- 3.74. Through the IAE Open Letter, we sought views on whether we should amend or remove Limb (a). Three respondents strongly disagreed with the proposal to amend or remove OFTO protection in the event of a force majeure event. They note that retrospective OFTO Licence changes could increase the OFTO’s risk profile and have a negative effect on investor confidence. One respondent considered that a common policy for force majeure events should apply to both OFTOs and Interconnectors.
- 3.75. We have considered the views raised by respondents and have decided not to remove Limb (a). We accept that OFTOs should be protected in the event of specified force majeure events.
- 3.76. Instead, the Authority intends to amend Limb (a) to remove reference to the STC and insert a definition of force majeure, which excludes reference to “*fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice)*”, into the OFTO Licence.
- 3.77. This will ensure clarity of the meaning of ‘force majeure’ in the OFTO Licence and enable Limb (a) to be interpreted as a standalone provision and not be dependent on the STC for interpretation nor subject to modification via the STC. It is unusual to have a situation where modification to a subordinate document would result in amendments to a previously issued licence. There is a specific procedure in the STC, which enables proposed modifications to the STC to be referred to the Authority for determination. Nothing in this document should be taken as prejudicing or fettering the Authority’s discretion in the event that a proposed code modification were brought before the Authority. Our decision to amend Limb (a) increases legal certainty by removing the alleged ambiguity from the drafting and ensuring the OFTO Licence is amended only through the appropriate s11A statutory process.
- 3.78. Moreover, we consider that the application of a “*fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice)*” has a narrow ambit in its application to IAEs. Fault or failure of plant and apparatus from some form of latent defect is most likely a result of a third party’s failure (even if not the OFTO’s failure) to abide by Good Industry Practice. We consider that the other listed examples of force majeure events properly encapsulate the circumstances in which protection is warranted under Limb (a), and that the reference to mere fault or failure of plant/apparatus is inapt in identifying those extreme supervening events, which characterise the definition of force majeure.
- 3.79. OFTOs have raised concerns in their responses to the IAE Open Letter that an OFTO Licence modification of this kind would increase their risk profile and have a negative effect on investor confidence. However, as made clear in the SSEC2 Decision, the circumstances when fault or failure of plant or apparatus would amount to an IAE under Limb (a) under the current OFTO Licence are very limited. In addition, the fault or failure would need to lead to a failure to comply with an obligation under the STC. These circumstances are very narrow, and any such circumstances can properly be assessed under sub-paragraph 15(c) of the IAE Condition, in accordance with

Ofgem’s policy. Accordingly, we do not consider that amending Limb (a) in the manner suggested will result in any material change to OFTOs’ investor risk profiles.

- 3.80. We intend to implement this decision by modifying the OFTO Licence, under section 11A of the Electricity Act 1989. Accordingly, we will run a statutory consultation on the proposed licence amendment in due course (see Section 5 for more information).

## IAE threshold increase

- 3.81. Although not raised in the IAE Open Letter, three respondents considered that the £1m minimum threshold for IAE claims, contained in Paragraph 15 (**IAE Threshold**)<sup>22</sup>, should be increased in line with inflation.
- 3.82. When the offshore regime was implemented, the Authority put in place two IAE Threshold bands, which were linked to the transfer value of OFTO assets. Three very small OFTOs (with a transfer value below £100m) have an IAE Threshold, set in their OFTO Licences, at £0.5m, while all of the other OFTOs licensed to date have a IAE Threshold set at £1.0m.
- 3.83. We do not consider that it is necessary or appropriate retrospectively to modify the OFTO Licence to change the existing IAE Threshold as this was the threshold that was determined and accounted for in financial calculations prior to licence grant. There is also no evidence that a change in the existing IAE Threshold will have any practical effect. There have been only four IAE claims to date, all of which have significantly exceeded the threshold level. However, we do recognise that, as projects have become larger, the level of the IAE Threshold as a proportion of the transfer value has fallen from an average of roughly 1:100 in tender round one to around 1:300 in tender round five. To ensure an ongoing link between the IAE Threshold and the transfer value of the OFTO assets, we intend to introduce two new IAE Threshold bands from tender round six onwards.<sup>23</sup> That is:
- a third band set at £2.0m where the project transfer value exceeds £500m; and
  - a fourth band set at £4.0m for any projects where the transfer value exceeds £1,000m.
- 3.84. We intend to implement this decision by modifying the OFTO Licence in accordance with the Electricity Act 1989. Accordingly, we will run a statutory consultation on the proposed licence amendment in due course (see Section 5 for more information).

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<sup>22</sup> Known as the Threshold amount or STC Threshold amount in the OFTO Licence.

<sup>23</sup> We do not consider it is reasonable to place this requirement on tender round five (TR5) OFTOs retrospectively; we did not specify this requirement the TR5 ITT documents, nor in the TR5 generic OFTO Licence.

## 4. Other views raised by respondents

### Impact on transmission use of system charges

- 4.1. A number of respondents considered that, where paragraph 15(c) of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) (the **IAE Condition**) allowed costs to be passed through, costs should not be borne primarily by offshore generators, and instead should be socialised. They considered that placing this risk onto offshore generators would result in: the generator becoming the 'insurer of last resort'; an increase in development costs; a windfall loss to wind farm developers (as they would bear the loss for both generation revenues and the cost of the Offshore Transmission Owners (**OFTO's**) repair); detrimental outcomes for consumers; and new investors being deterred.
- 4.2. Two respondents stated that generators should not be required to cover the risks of an asset they have no control over. One respondent considered that greater socialisation of these costs would ensure consistency with the framework for onshore Transmission Owners (**TOs**) and ensure there was no discrimination between onshore and offshore connected generators. Three respondents were of the view that generators would increase Contract for Difference (**CfD**) bid prices to protect themselves against these types of events.
- 4.3. The policy proposal set out in the IAE Open Letter does not change the way in which Transmission Network Use of System (**TNUoS**) charges operate in relation to the IAE Condition and in any case, the TNUoS charging methodology is outside of the scope of the IAE policy consultation. We are not proposing any changes to the TNUoS charging methodology, set out in section 14 of the Connection and Use of System Code (**CUSC**).
- 4.4. However, we note the views of a number of respondents that all successful IAE claims should not be borne by offshore generators. Our policy position to impose a deductible on Uninsurable IAE Claims<sup>24</sup> does mean that OFTOs will be liable for some of the costs of successful Uninsurable IAE Claims (we discuss this further in paragraphs 3.43 to 3.63). In addition, if generators provide comprehensive warranties it would decrease the likelihood of OFTOs seeking to recover costs through the IAE Condition thereby resulting in IAE costs not being passed through to generators (see paragraphs 3.64 to **Error! Reference source not found.** for further information).
- 4.5. We have also forwarded these comments to Business, Energy and Industrial Strategy (**BEIS**) for consideration in relation to the broader offshore energy policy.
- 4.6. We note that parties to the CUSC can propose a CUSC amendment if they do not agree with the TNUoS charging methodology contained in the CUSC and believe that the proposed modification would better facilitate the relevant objectives under Standard Condition C5(5) of National Grid Electricity Transmission (**NGETs**) electricity transmission licence. Section 8 of the CUSC sets out how the CUSC can be amended. Nothing in this document should be taken as prejudicing or fettering the

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<sup>24</sup> See section 3 of this document for more information on Uninsurable IAE Claims.

Authority's discretion in the event that a proposed code modification were brought before the Authority.

## Additional issues

- 4.7. Respondents raised a number of other issues in response to our consultation published on 6 February 2018 (the **IAE Open Letter**). These are set out below. Where relevant we have taken these responses into account during our decision-making process. However, a number of the responses were beyond the scope of the IAE Open Letter.

### *Proposed alternative approach*

- 4.8. Four respondents proposed an alternative approach to Income Adjusting Event (**IAE**) claims, which would:
- 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 a similar root cause dating before asset transfer.
  - 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) oblige the OFTO to maintain insurance cover with a LEG3 exclusion and to provide an independent annual report confirm that it has this level of insurance or confirm that the next best available insurance cover has been placed.
- 4.9. We note that the IAE Condition already requires that the costs claimed are assessed on an economic and efficient basis and must be directly caused by the IAE. We have clarified that we continue to expect that the first failure event will ordinarily be protected by insurance, warranties and/or other commercial recourse and is therefore unlikely to result in an IAE claim. However, all IAE claims made under the IAE Condition, including one relating to a first failure event or one resulting from the same root cause, will be assessed against the four factors set out in paragraph 1.6 above. The Offshore Transmission Owner Licence (**OFTO Licence**) already specifies the obligations to which OFTOs must adhere; it is not appropriate for developers to determine how OFTOs must manage their own assets. Additionally, we have set out the minimum level of insurance protection that OFTOs must obtain. Therefore, we do not consider that the proposal above is appropriate.

### *Holistic Review*

- 4.10. A number of respondents proposed an holistic review of the offshore transmission regime. Respondents set out a number of reasons why they considered that an holistic review was necessary in their responses, including that:
- the offshore regime is now 9 years old
  - Ofgem committed to a review at the inception of the offshore regime, and

- a further round of CfD is about to commence which has implications for project financing.
- 4.11. The same respondents noted that *“industry is proposing an offshore wind sector deal which would review market arrangements and include the development 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. As such, we would like to see the future policy of income adjusting events taken forward in this wider context.”*
- 4.12. One respondent set out four policies that in their view need to be considered now and in the future:
- The CfD framework and the competitive auctions offshore wind developers participate in: *“offshore wind developers will only build projects if they are successful in the CfD Allocation Rounds. The Allocation Rounds are run by auctions, ensuring that there is a competitive pressure between developers and that only the most cost-efficient projects will be built. This provides strong incentives on developers to drive down their costs and find innovative solutions.”*
  - The CUSC and Security and National Electricity Transmission System Quality of Supply Standard (**SQSS**) provisions on outages and compensation; *“the provisions of the SQSS and CUSC lead to offshore wind generators not being compensated for any OFTO faults.”*
  - Charging provisions set out within the CUSC: *“the charging provisions within the CUSC determine how any changes to an OFTO’s revenue feed through to the connecting offshore wind generator. As Ofgem is the decision maker on CUSC changes, any views on OFTO policy must take into account the resulting charging impact”, and*
  - The OFTO framework: *“Ofgem needs to consider the principles behind the OFTO tenders and framework. The OFTO tenders are a competitive process in which the OFTOs willingly participate. The burden should be on the OFTOs to perform their due diligence and price in risks appropriately, according to the regulatory framework that applies.”*
- 4.13. We consider that an holistic review of the offshore regime is outside of the scope of the IAE Open Letter. The offshore transmission regulatory regime has proven to be flexible and to deliver the co-ordinated offshore grid we need for the offshore regime to be as economic and efficient as possible. We do not propose to undertake a broader review of the offshore regime as we consider that the offshore regime continues to deliver lower costs to consumers. We estimate that the regime has saved between £0.7bn and £1.1bn over the first three tender rounds (independent evaluation by CEPA) and made a major contribution to the UK's renewable energy targets. We have licensed 17 OFTOs with a further 7 in the pipeline which has resulted in an estimated £5bn in investment (up to tender round five) and 4.6GW of connected renewable generation (tender rounds one - five). The offshore transmission regulatory framework has been designed to be, and has proven to be, flexible and to deliver offshore generation in an economic and efficient manner, allowing us to run tenders for projects where:
- OFTOs design, build, operate and maintain the transmission assets, or

- Generators build the transmission assets and then transfer them to OFTOs at construction completion.

4.14. In any case, we have informed BEIS about the views raised by respondents that an holistic review of the offshore transmission regime is required.

#### *Pre-emptive repairs*

4.15. Four respondents considered that the offshore regime should encourage OFTOs to make pre-emptive repairs as this would reduce IAE costs. One respondent commented that in its experience: *"generators' and OFTOs' interests are not aligned when it comes to revenue losses caused by a failure, and as a result, OFTOs do not react as quickly to problems developing on assets as generators would, acting in line with our understanding of industry best practice, leading to increased downtime and consumer impacts through the counterfactual of increased carbon emissions and fuel costs through generation substitution"*.

4.16. We consider that both the OFTOs' and generators' interests are aligned when it comes to minimising outage times. Both parties are financially impacted by the duration of an outage and there is no certainty that an OFTO will be able to recover all or any of the costs that it incurs from the outage through the mechanisms in the OFTO Licence. Additionally, failure by an OFTO to comply with its licence obligations could result in enforcement action under section 25 of the Electricity Act 1989. OFTOs are obliged to maintain the transmission assets in good operating order at all times.

4.17. In addition, market mechanisms operate to ensure both quality efficient repairs are undertaken, for example, an OFTO's financing obligations are likely to require that it complies with its licensing requirements. Insurers also impose requirements on OFTOs to have emergency response plans and to undertake the repairs in as efficient a manner as possible. We note that some lead insurers insure both the generator and OFTO for the same windfarm and are therefore strongly incentivised to ensure efficient repairs are undertaken, as they will be required also to pay for the generator's business interruption insurance policy beyond the deductible period of around 45 days.

4.18. We agree that pre-emptive repairs should be carried out where there is strong evidence that cables are likely to fail imminently. Pre-emptive repairs are likely to cost substantially less than repairs where the cable has already failed, and the outage needed for the repairs is significantly shorter.

4.19. Pre-emptive repairs therefore seem to be in the interest of all of the parties concerned. OFTOs stand to benefit from lower repair costs; OFTOs and generators would benefit from the shortened outage period as well as the lower value of any potential IAE claim; and insurance companies would benefit from lower claims.

4.20. However, an Operational All Risk (**OAR**) insurance policy with a LEG3 exclusion will not always cover pre-emptive repairs. OAR policies are designed to cover damage. As an example, the breakdown of fibres within a fibre optic cable (**FOC**) as we have seen in the past are unlikely to be sufficient to meet this threshold where the cable remains operational. An OFTO must be able to demonstrate that sufficient cable damage has occurred meaning that a failure of the cable is imminent. This puts OFTOs in a difficult position because they have to decide whether to make the pre-emptive repair without knowing whether their insurance will pay out or not (whether

damage has occurred will only become clear after the technical investigation has taken place).

- 4.21. A breakdown of fibres within a FOC do not always mean that a failure will occur imminently. In this regard, we note a case where all fibres in one of the three export cables have failed and a number in the second cable. This occurred approximately two years ago and at the time it was believed that the cables would fail imminently. Yet they have not failed to date and the OFTO has maintained communications through other channels.
- 4.22. We therefore encourage the different industry parties to work together to determine the best way forward. In particular, we encourage insurance companies to work with OFTOs and generators to see whether they can develop specific policies for pre-emptive repairs.

#### *Generator consultation*

- 4.23. One respondent suggested that generators should be involved in the IAE determination process and be able to comment on whether the event in question is indeed uninsurable. The IAE Condition allows the Authority to consult relevant parties. We consider this provides sufficient opportunity for the relevant generator to provide its views on the event in question in each case where relevant and appropriate.

#### *Quality of operation and maintenance practices*

- 4.24. One respondent considered that OFTOs should demonstrate that their operation and maintenance (**O&M**) programmes are ongoing and in line with Good Industry Practice. One respondent considered that, given the risk faced by developers, OFTOs should consider the developers offer to carry out O&M.
- 4.25. We assess the quality of each bidder's proposed O&M response as part of the tender evaluation process prior to granting each OFTO Licence. We are satisfied that this requires OFTOs to demonstrate that they have appropriate O&M practices in place.
- 4.26. Additionally, one of the factors that we consider when we assess an IAE claim under Paragraph 15(c) of the IAE Condition is the ability of the OFTO to manage the risk or impact by putting in place and pursuing risk management arrangements such as insurance, commercial recourse against third parties and/or operating practices. This includes an assessment of whether sufficient O&M has been undertaken. We then apply an economic and efficient test when assessing the costs incurred for a successful IAE claim.

#### *IAE costs*

- 4.27. A number of respondents were of the view that IAE costs awarded as a result of successful IAE claims must be transparent so that generators can scrutinise them and challenge them if they wish.
- 4.28. The Authority will publish the quantum of a successful IAE claim once it has been determined. The costs claimed are assessed on an economic and efficient basis and must be directly caused by the IAE. The quantum is also reduced by any sum



recovered from third party commercial recourse and, under our policy position outlined above, Uninsurable IAE Claims will be further reduced by the deductible.

- 4.29. The assessment conducted by the Authority forms part of our statutory functions and is conducted on an impartial basis to satisfy the requirements of the OFTO Licence condition.

#### *Management of major failure events*

- 4.30. Three respondents considered that OFTOs and generators should be able to engage to discuss joint management and execution of repair and that generators' insurers should be allowed to step in to make repairs.
- 4.31. The transmission assets are owned and operated by the OFTO. The OFTO must endeavour to make its transmission system available to the System Operator in accordance with standard condition E15 (Obligation to provide transmission services) of the OFTO Licence and Good Industry Practice to minimise the effect and duration of any Transmission Service Reduction. Thus, it is for the OFTO to maintain control of the transmission assets and to determine the most appropriate course for repair of the assets.
- 4.32. That said, as previously stated, we recognise the mutual interest of OFTOs and generators in efficiently managing repairs to transmission assets. We therefore encourage generators and OFTOs to work together efficiently to address these issues.
- 4.33. In this regard, we also note that it is common practice for some leading insurers to insure both the generator and OFTO for the same windfarm, which gives the insurer both visibility and control of the repair of the transmission assets in order to minimise its exposure under the generator's business interruption insurance.

#### *Availability incentive*

- 4.34. One respondent considered that the availability incentive did not incentivise repairs.
- 4.35. We consider that the availability incentive does incentivise repairs. Paragraph 10 of Amended Standard Condition E12-J4 of the OFTO Licence requires the Authority to assess whether "the licensee had taken reasonable steps, consistent with Good Industry Practice, to manage the impact of the event on the availability of services" when determining the level of adjustment to be applied for an Exceptional Event. In practice, the Authority has reduced a number of Exceptional Event claims, where the contractors engaged by the OFTO have delayed the repair because of inefficient practices. Thus, there is a direct financial penalty under the availability incentive for OFTOs that do not undertake repairs in a manner consistent with Good Industry Practice.

#### *OFTO build*

- 4.36. One respondent considered that Ofgem should increase its focus on OFTO build.
- 4.37. We consider that future development of the offshore regime towards an OFTO build model could achieve even greater savings for consumers and could result in a

number of the risks, set out above, being mitigated. We will continue to encourage generators to consider this model in future tender rounds.

## 5. Next steps

- 5.1. In order to progress three of our policy positions, modifications to the Offshore Transmission Owner Licence (**OFTO Licence**) will be required. The policies requiring licence modifications are:
- imposing the deductible (which is intended to apply differently to existing and future Offshore Transmission Owners (**OFTOs**))
  - modifying Limb (a) of Paragraph 15 of the Condition (which is intended to apply to all existing and future OFTOs in the same way), and
  - increasing the IAE Threshold (which is intended to apply to future OFTOs only).
- 5.2. Before making any modifications to the OFTO Licence, the Authority will give notice of its intention to make modifications and carry out appropriate consultations in accordance with the Electricity Act 1989 (the **Act**).
- 5.3. The Authority intends to progress the policy positions requiring licence modifications through the legislative mechanisms set out in table 1 below.
- 5.4. We expect to publish a statutory consultation setting out the proposed OFTO Licence modifications in early 2019.

Table 1

	<b>Policy position:</b>	<b>Proposed modification to OFTO Licence via:</b>
1	Imposing a deductible for existing OFTOs (to be the same amount as the insurance deductible set out in the bid for each OFTO).	s11A(1)(a) of the Act. The proposal is that all OFTO Licences held by existing OFTOs would be modified to impose the deductible.
	Imposing a deductible for future OFTOs (to be set at £5m or the insurance deductible set out in the OFTO's bid, whichever amount is higher).	s8A(2) of the Act. The proposal is that all OFTO Licences of future OFTOs would be modified to impose the deductible prior to licence grant.
2	Modifying Limb (a) of Paragraph 15 in the same manner for all existing and future OFTOs.	For existing OFTOs: s11A(1)(a) of the Act. The proposal is that all OFTO Licences held by existing OFTOs would be modified to amend Limb (a) of Paragraph 15.  For future OFTOs: The proposal is that all OFTO Licences of future OFTOs would be modified to amend Limb (a) of Paragraph 15 via s8A(2) of the Act prior to licence grant.
3	Increasing the Threshold amount for future OFTOs only.	s8A(2) of the Act. The proposal is that the IAE Threshold for future OFTOs will be modified prior to licence grant. The threshold amount will be dependent on the transfer value of the OFTO assets in each case.