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Reference: IAE policy in Offshore Transmission Licences
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Dear Akshay,

Response to: Consultation on Income Adjusting Event policy in Offshore Transmission Licences

As both the operator and developer of several offshore wind farms, Innogy Renewables UK Ltd (“innogy”) welcomes the opportunity to respond to this consultation regarding Ofgem’s Income Adjusting Event policy for existing and future OFTOs. Our answers to Ofgem’s consultation questions can be found in annex A.

Ofgem’s consultation is narrow in its scope and in considering the effects of the proposed policy. The proposals aim to maintain the viability of the OFTO regime, and formalise the allocation of risk in relation to the cost of repairs to OFTO-owned assets. This ultimately pushes costs of repairs onto Developers¹ which changes the cost profiles of projects, and could lead to increased consumer costs. The proposals in the consultation are merely a ‘sticking plaster’, addressing just one aspect of the OFTO arrangements, as such there is a high possibility of creating unintended consequences in the areas of investor certainty, policy integrity and in the insurance market. The matter should be considered as part of a holistic review of the OFTO regime.

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

¹ As do Ofgem in the Renewables Obligation guidance, we use the terms ‘Developer’ and ‘Generator’ interchangeably throughout this response with the same meaning.

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

- The consultation states that the licence effectively provides “insurance of last resort” for existing OFTOs (page 5). The reality is that in the case of IAEs and “uninsurable” events, it is the wind farm developer that provides this ‘pseudo’ insurance. We believe that this should not be permitted for the reasons outlined in our answer to question one.
- Ofgem’s policy for ‘future OFTOs’ should apply only from TR6 at the earliest, not TR5. TR5 projects are too advanced to be considered ‘new’. Applying ‘new’ policy to those wind farms and OFTOs would be retroactive application of policy and damaging to the business cases of those assets and future investor confidence.
- All pass-through costs from OFTO to third parties (eg Developers) must be scrutinised by Ofgem in a similar way to the costs of asset transfer from Developer to OFTO. The consultation fails to address how efficient repairs would be incentivised.
- We support a deductible applied to events considered to be “uninsurable”, at least at the level proposed of £5m or 30% (whichever is higher). We would not support a deductible of any less than 30%.
- A third party (eg Developer) who has costs passed-through to them must have some formal route to challenge those costs where they do not deem them to be economic, efficient and reasonable. To facilitate this process a full cost breakdown for any corrective works should be made available to the relevant Developer.
- OFTOs must be able to demonstrate to Ofgem that operation & maintenance (O&M) is ongoing and has been undertaken since the time of asset transfer in line with good industry practice.
- Ofgem should consider whether pass-through costs from IAEs are best passed-through to Local TNUoS or Wider TNUoS. Passing these costs into Wider TNUoS could lead to the consumer being better off.

We look forward to responding to any future consultations on licence amendments as required to implement formalised IAE policy.

Yours sincerely,

Nicola Percival

Policy & Regulations Manager
Innogy Renewables UK Limited



1. Do you agree with our assessment of the benefits and risks of the existing IAE policy, and the proposal to formalise and strengthen it as suggested above [within the consultation]?

We agree that Ofgem should formalise the policy for IAEs.

Ofgem's existing IAE policy for wind farms in TR4 or earlier

The consultation states that the licence effectively provides "insurance of last resort" (page 5). The current reality is that in the case of IAEs and "uninsurable" events, it is the wind farm developer that provides this 'pseudo' insurance. The comparison with the PF2 regime seeks to justify Ofgem's current policy where the premise for this is Ofgem's decision in regard to GyM SSEC2 (refer to "GyM SSEC2 decision" in the consultation itself):

- The consultation refers to precedents set in public private partnerships (PPP) projects where the cost of insurance is deemed not to be value for money or is unavailable/excluded in the marketplace.
- In such cases where the insurance is not deemed to be value for money HM Treasury guidance on PF2 contracts concludes that "it is likely to be better value for money if an Authority provides a limited level of protection under specific circumstances" for risks that become uninsurable.
- The "Authority" referred to is generally the public sector counter-party who has made a conscious decision in this regard.
- In the context of Offshore Wind Generators and OFTOs, Ofgem see that the "Authority" ultimately means costs falling to Offshore Wind Generators who have not made a conscious decision in this regard. This policy is in effect now, where the premise for this is Ofgem's decision in regard to GyM SSEC2 (refer to "GyM SSEC2 decision" in the consultation itself).

This effectively means that where insurance may be unavailable or excluded in the market place, or it is available but deemed to not be value for money, that the generator would bear the costs of cable failures.

We believe that this should not be permitted. Existing offshore wind generators (and any Developer who has signed any contracts in relation to future offshore wind farms) have not included the risk of cable failure into their operations costs due to Ofgem's approach 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 OFTO licensees from all such risks. We consider that latent defects are foreseeable types of risk, and OFTO licensees should put in place appropriate commercial arrangements to manage or absorb these risks".

Existing OFTOs have built the cost of insurance into their bids, taking a commercial decision in relation to the level of cover². Inadequacy of any insurance cover procured, and the associated risk, should therefore be attributable to the OFTO alone.

Ofgem's approach to existing IAE policy as described in the consultation is effectively a windfall loss for the affected generator with no means of recovering the loss. This risks affecting future investor confidence in UK offshore wind assets. It also risks being taken into consideration by bidders resulting in inflation of CfD bid prices due to all Developers acting to protect themselves against an event that will ultimately only impact a small sub-set of projects. It is therefore far from clear that Ofgem's approach to IAE policy does actually result in the best outcome for consumers.

With reference to Ofgem's statement that significant pass-through costs from OFTO to generators as a result of IAE policy being applied should be incentive for generators to build fit-for-purpose assets, innogy believe that generators are already under significant pressures to build high-quality assets. The loss of revenue from electricity sales and any subsidies alone is sufficient incentive to develop critical export infrastructure. Reputational pressures also apply in this regard.

Ofgem's approach to IAE policy for wind farms in TR5 and beyond

We support Ofgem's approach that all OFTOs should have LEG3 insurance cover as a minimum. Whilst it is clear in the consultation that Ofgem will require this of new OFTOs it is not clear whether Ofgem will require existing OFTOs to have LEG3 insurance cover as part of their proposed IAE policy. We suggest that Ofgem should at the very least recommend this for existing OFTOs. All OFTOs (existing and new) without this cover are operating entirely at their own commercial risk, and IAEs should not be available for OFTOs operating with less than comprehensive LEG3 cover.

We also agree with Ofgem that OFTOs must be appropriately incentivised to procure and keep insurance wherever possible. We support a deductible applied to events considered to be "uninsurable", at least at the level proposed of £5m or 30% (whichever is higher). We would not support a deductible of any less than 30%. We also support that IAE claims would be capped at the reinstatement value of the asset, and claims paid as net of all avenues of commercial recourse. It is not clear if or how the costs of repairs and IAEs in relation to the policies described in the consultation are scrutinised, and the consultation contains no proposals to introduce a robust and transparent process for cost assessment. We propose that all costs which are determined to be 'pass-through' from the OFTO to a third party (eg the Developer) should be assessed for rea-

² Paragraphs 51 and 59

https://www.ofgem.gov.uk/system/files/docs/2017/09/determination_in_relation_to_notice_of_an_income_adjusting_event_from_gwynt_y_mor_ofto_plc.pdf

sonableness and cost efficiency (ie market tested and demonstrating the efficiencies expected from a responsible operator). Where costs are deemed inefficient, uneconomic or unreasonable they should not be allowed to be passed-through. This would incentivise efficient and economic repairs. As it does not own the OFTO asset or manage repairs, the Developer currently cannot mitigate the risk of poor management or repair works resulting in higher costs, and has no route to challenge those costs even when they become aware of what they are. We propose that a robust, formal process be implemented such that third parties (eg Developers) to whom costs are passed through can challenge these where they see fit. Full cost breakdown for any corrective works should be made available to the relevant third party, in order to facilitate transparency.

In addition, timeliness of repairs is also crucial for generators as time lost where the OFTO asset cannot export electricity / export is limited result in the generator bearing the significant costs of lost generation. Currently generators have no control over repair costs (as described above) or urgency of repairs, which can lead to significant costs in lost generation. The OFTO ‘availability incentive’ has not, in our experience, incentivised an OFTO to carry out timely repairs.

As financial entities, OFTOs may not be the best equipped party to be carrying out repairs. We would welcome a mechanism whereby OFTOs are required to engage with the relevant generator to discuss potential support or synergies that could be offered through jointly managing and/or executing relevant repairs. There may be circumstances where generators can call upon contacts or best practices that help improve efficiencies, timeliness of repairs and reduce the OFTO’s costs. There may also be circumstances where the OFTO would wish for the generator to project manage the repair to increase efficiencies and such possibilities should be encouraged through the IAE policy. The OFTO should not expect that the generator would take responsibility for costs incurred, as they do not own the asset.

With reference to the proposed minimum protections that Ofgem wish Developers to offer to OFTOs outlined on page 6 of the consultation:

Cable (as-set?) failure	Insurance / warranty / indemnity arrangement	Effects
0-5 years operational (from TR5)	<p>OFTO would have comprehensive LEG3 insurance cover AND full contractor/generator warranty/indemnity.</p> <p><u>Result = generator pays majority of costs where contractor warranty has expired.</u></p>	<p>Contractor warranties unlikely to cover more than 5 years. Generator would have to underwrite any years not covered at its own cost.</p> <p>OFTO would have built cost of LEG3 insurance cover into OFTO bid, but wouldn’t use it in this scenario as it would push up premiums**.</p>

		<p>The costs associated with the perceived 'risk of IAEs' could lead to increased consumer costs, as the cost of risk is likely to be passed through in some way to the consumer. In addition the risk would be covered once in the OFTO's insurance cover (paid for by the generator in the tender revenue stream) and for a second time by the generator underwriting the risk where a third-party warranty may have expired. This risk may be built into the cost profile of the project, amplifying the CfD bid.</p>
<p>5+ years operational (from TR5)</p>	<p>If first failure since year 0: LEG3 insurance <u>should</u> cover. A failure will only be deemed an IAE in "exceptional circumstances"†, which could include insurance cover being withdrawn or excluded on the basis that "first failure"* is deemed to have occurred.</p> <p><u>Result = LEG3 insurance claim or,</u></p> <p>If insurance cover declined / withdrawn / excluded or not first failure since year 0: If insurance cover declined on grounds it is "uninsurable" then IAE Condition would likely deem this an IAE.</p> <p><u>Result = OFTO will pay £5m/30%, generator will pay the rest.</u></p>	<p>Generator could be liable for cable repair costs (where they are deemed "uninsurable") for the remainder of the asset lifetime.</p> <p>Depending upon the definition of "first failure"* generators could not be comfortable that the costs would not be passed through to them, even in the first instance of a specific failure of a specific cable at that wind farm site.</p> <p>As this would change the cost profile of a project the risk may be built into CfD bids. If so, this could push up costs for consumers.</p>

† Not defined * Not defined

** When would OFTO need LEG3 cover from? At the point of asset transfer from Developer to OFTO, after 5 years?

An alternative way to pass-through costs which are “uninsurable” - which would likely save the consumer money - would be to socialise the full costs of IAEs to be paid for by passing them through to wider TNUoS. This would avoid ‘perceived risk’ being costed into projects by OFTOs or generators which would ultimately be passed-through to the consumer. The Wider TNUoS approach would only result in costs being passed-through to the consumer in the rare event of an IAE. Given that Generators are already incentivised to build robust assets, as long as the OFTO insurance arrangements are appropriately incentivised - and any pass-through costs appropriately scrutinised - this could be an opportunity to protect consumers from inflated costs and incentivise appropriate behaviours from both Generators and OFTOs. Ofgem’s statement on page 2 that the matter of how the costs are borne “*is determined by the terms of section 14 of the CUSC and not by the Authority*” is not completely correct, as the Authority (Ofgem) are responsible for approving or rejecting code modifications.

Safeguards and warranties

With reference to “the proposed minimum protections that Ofgem wish Developers to offer to OFTOs”:

- Warranties are already provided at the point of asset transfer from the Developer to the OFTO. We ask that Ofgem clarify why these commercial protections are not enough.
- Cable manufacture and laying is a complex process, with many different companies playing a role. It is not clear how an extensive warranty from the cable manufacturer and/or installer could be guaranteed on every project at a cost-effective price. This proposal could lead to Developers underwriting risks as ‘pseudo-insurers’ and OFTOs being disincentivised to seek appropriate insurance for assets which they own and are responsible for.
- We are aware that operating phase insurances would not be appropriate to cover manufacturing / construction related failures.
- Developers retroactively procuring insurance cover for projects in TR5 (which are under construction) is not possible. Insurance contracts are already bound, and we have been made aware that the insurance market will not allow projects that are in construction or post-construction to amend their construction insurance policies.

We therefore request that, as a minimum, Ofgem clarify that TR5 projects will not be required to procure additional insurance. Ofgem should not be mandating requirements on developers, particularly in relation to existing construction contracts – the competitive CfD framework drives developers to try and find the most efficient solution. To do so in this way would be retroactively changing policy. The proposed protections need refining and should apply only from TR6 at the soonest.

In the event that the policy is applied to TR5 projects we need clarity that the relevant construction warranties should be effective from the point of takeover by the developer from the contractor (known as 'sectional completion') of the relevant assets. The precise definition of this point might vary from contract to contract. We would therefore welcome some more detailed drafting of the policy wording that could be discussed and refined with industry to ensure there are no unintended consequences due to the retroactive impact of the policy on signed contracts, particularly for TR5.

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

Ofgem has identified that the IAE changes proposed could drive OFTOs not to seek, and insurers not to provide, appropriate insurance for latent defects. Such interference in the market may not be advisable and Ofgem needs to monitor whether any changes which are made to IAE policy do drive efficient behaviours.

We have also identified several areas where Ofgem should clarify their meaning to avoid unintended consequences, set out below:

Clarification of scope

The consultation uses inconsistent language throughout. It refers to both "cable failure" and "asset failure". Please can Ofgem clarify where they are referring solely to cables (as in the case of the warranty proposals?) or the wider offshore transmission asset (for application of IAE policy as per the licence condition?).

We expect that each case would be assessed on its own merits, and request that Ofgem make a statement 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.

Definition of "uninsurable"

The definition of "uninsurable" must be clear. It must also be tested against a broad range of situations and prove to be robust before it can be implemented. The reference to "exceptional circumstances" on page 5 also requires defining. This is an area of obvious concern for the potential to create unintended consequences.

The IAE policy around “uninsurable” must require that an OFTO which believes it is dealing with an “uninsurable” situation provides adequate evidence of such before any pass-through of costs (less deductible) to third parties. This includes providing robust evidence that insurance was comprehensively sought but unavailable in the market, in line with the definition. The costs should be fully scrutinised by Ofgem to ensure cost efficiency and value, like in the case of determining asset transfer value.

Related to ‘clarification of scope’ above, second events of failure should not automatically be considered IAEs. They must be assessed on their merits, whether “uninsurable” or not. Ofgem’s proposed policy, and the wording of the consultation, suggests that insurance companies could choose not to insure “bad risks”. Furthermore, 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.

“First failure”

How is “first failure” defined / to be interpreted? This could refer solely to the specific failure of one specific cable at one wind farm for a specific reason, or it could refer to a specific failure of one type of cable at one wind farm and then be interpreted to apply to all cables of that type at any wind farm. We believe that the former is a more appropriate high-level interpretation than the latter.

It is unhelpful to refer to this being relevant unless Ofgem have a clear understanding of what this should mean and how it should be applied in specific situations. Even then issues of interpretation will potentially lead to issues in the future.

“Handover of completed assets to Developer”

As noted above each contract will have its own definition of the handover process. Cable contracts generally foresee a handover at ‘sectional completion’ which is following the successful installation. We would therefore welcome some more detailed drafting of the policy wording that could be discussed and refined with industry to ensure there are no unintended consequences due to the retroactive impact of the policy on signed contracts, particularly for TR5.

“Estimated transfer value”

Could Ofgem please confirm whether this refers to Initial Transfer Value or Indicative Transfer Value?

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

We suggest that the £1m value, which must be demonstrated as part of Paragraph 15 of the IAE Condition, be reviewed and amended to a more appropriate figure. The £1m has been fixed in the STC without any links to inflation, and therefore it is out of date.