

Offshore Licensing
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Ørsted Response to Ofgem's Income Adjusting Event Policy Consultation

9 March 2018

Our ref. Ofgem IAE Consultation
Response

The Ørsted vision is a world that runs entirely on green energy. Ørsted develops, constructs and operates offshore wind farms, bioenergy plants and innovative waste-to-energy solutions and provides smart energy products to its customers. Headquartered in Denmark, Ørsted employs 5,600 people, including over 900 in the UK. Ørsted is the largest offshore wind farm developer, generator and owner in the UK, and the world. We have wind farms with Offshore Transmission Owners (OFTOs) from every Tender Round, including the world's largest offshore wind farm, London Array. We currently have 8 OFTOs connecting our offshore wind farms, and have 3 more offshore wind farms currently going through the OFTO tender rounds.

Summary

We welcome Ofgem's consultation, and view that it is timely as there have been several Income Adjusting Event (IAE) decisions recently. It represents an appropriate opportunity to provide clarity to offshore wind farm developers, existing offshore wind farm generators, as well as existing and prospective OFTOs. However, we strongly disagree with the positions that you have set out in your consultation. Ofgem's proposals are an unnecessary, significant intervention in a competitive market, will lower investor confidence, drive up the costs of offshore wind, and as a result will increase the costs that consumers face.

Ofgem's proposed changes to the IAE policy will effectively make offshore wind farms the insurer of last resort for the OFTO. This is a retrospective policy change that undermines the regulatory certainty underpinning the GB regime.

Ofgem has also proposed to impose requirements on offshore wind developers through existing and future OFTO tenders. 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. Your proposals will reduce the flexibility developers need to drive efficient solutions, and increase the costs that developers face. It will also adversely affect wind farm developers who have bid for Contracts for Difference (CfD) in recent rounds on the basis that they can negotiate the most cost-effective solutions with the supply chain.

Further, we consider that Ofgem's proposals in this area effectively represents an attempt to treat the symptoms of the OFTO framework, instead of the flaws of the OFTO framework. Our view is that a more fundamental review is needed. This review should occur soon, as the industry now has significant experience with the OFTO framework, and the offshore wind market has fundamentally evolved since the OFTO regime was conceived 10 years ago.

Context

The offshore wind industry has developed significantly since the OFTO regime was designed 10 years ago. Offshore wind farms are now only built after going through the competitive CfD auctions, where we have seen the combination of rapid industry developments and competitive processes leading to large declines in costs; the first CfD wind farms cost £150/MWh, the most recent wind farms, including our Hornsea Project 2, cost £57.50/MWh. The result of these auctions clearly show that offshore wind farm developers have the right incentives, and are competing to drive down costs to consumers.

One of the key levers in these cost reductions has been bringing new investors and financiers into the offshore wind market. The offshore wind market has moved from being dominated by traditional utilities, to a market with new investors, such as investment funds and pension funds. This change has been enabled by the certainty of the CfD regime, the steps that developers have taken to reduce the risks of their projects and the regulatory certainty that underpins the GB regime. You have highlighted in your open letter the impact of unexpected costs on OFTOs as thinly capitalised entities. Many of the investors that have driven down the costs of offshore wind are in the same position and unexpected costs that arise from the regulatory framework will have a significant negative impact on investor confidence and future costs of financing.

There have been several IAEs from OFTOs recently as they have experienced failures on their export cables. While these events are costly, they are rare, and the recent series of export cable failures on an older cable design do not represent a long-term trend. Ofgem therefore needs to ensure that if it makes changes to its IAE policy, they are proportionate and not simply reactionary.

Further, the impact and risks of OFTO failures is highly asymmetric between the OFTO and the connecting offshore wind generator¹. The OFTO availability incentive strictly limits their exposure to any events, can be adjusted as an exceptional event, and can also potentially be offset by their performance during other periods. The offshore wind generator has none of these protections and is fully exposed to the costs of any outages. As a result, the OFTO regime places significant risks on the offshore wind generator, which also leads to offshore wind developers being strongly incentivised to ensure the OFTO does not have any failures on their assets after they have been transferred.

¹ We refer to offshore wind generators to represent existing and built offshore wind farms, and offshore wind developers to represent wind farms that are being developed or in construction

Insurer of Last Resort

Ofgem has set out that the OFTO licence and IAE provisions represent an insurer of last resort policy. Combined with the view that these costs should be passed through to offshore wind farm generators means that Ofgem is effectively proposing that these generators must bear the costs of being insurers of last resort for the OFTO. This represents a retrospective change of policy and risk sharing. It will place unexpected costs on existing offshore wind generators, and increase the costs of financing future offshore wind projects due to the increased regulatory risk and uncertainty.

Proposed Tender Requirements

Further, we view that it is inappropriate that Ofgem sets explicit requirements through the OFTO transaction process on how offshore wind farm developers construct their wind farms, and the contractual arrangements they need to commit themselves to. Prescribing contractual terms for offshore wind developers is a significant intervention in a market where Ofgem does not have this remit. It will limit innovation and may push the costs of future CfD contracts higher and overall costs to the consumer.

In addition, the OFTO framework is in principle a competitive framework; prospective OFTOs should be performing the necessary due diligence and pricing in risks that they see based on how the offshore wind farm has been developed. Setting explicit requirements should not be necessary, and isn't appropriate.

Further, it will also not be feasible for many developers to meet your proposed requirements. Many developers will have already signed into and agreed their Engineering, Procurement and Construction (EPC) contracts. If Ofgem does settle on mandating requirements on developers, we view they should not impact any developer that may have already signed contracts before Ofgem has made a decision. If imposed, these requirements should only impact offshore wind farms from CfD Allocation Round 3, and beyond.

Risks on Regulated Assets

Overall, we view that the risk of unexpected, uninsurable events on regulated assets should be socialised, where Ofgem can use their powers to assess whether an OFTO has acted efficiently. This ensures that offshore wind farm generators are not required to cover the risks of an asset they have no control over, and do not own or maintain. This is also consistent with the framework for onshore Transmission Owners (TOs) and ensures there is no discrimination between onshore and offshore connected generators. It is also consistent with the PF2 guidance Ofgem has been using, which states there are situations where it is efficient for the public (referred to as an Authority in the guidance) to cover these risks. Further, if the risks are socialised, it avoids the need for potentially inefficient and expensive arrangements to cover uninsurable events that may never arise or that unnecessarily increase TRS.

Consultation Period

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Response

We would highlight that these proposals have been issued with a 4-week consultation period. Ofgem's proposals will fundamentally impact not just the OFTOs, but current offshore wind generators, future offshore wind developers, investors, insurers and manufacturers. This requires a more extensive consultation period to ensure that all parties have the opportunity to understand your proposals and provide feedback.

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?

No, we strongly disagree with Ofgem's assessment. The impact of the IAE policy on offshore wind generators, and offshore wind developers, needs to be considered as part of this policy, and not simply the potential impact on OFTOs. Further, we are concerned that Ofgem has not fully assessed, if any, what the impact on the OFTO's commercial and insurance arrangements will be, and the resulting impacts on the TRS that OFTOs require. This analysis could show that it is more efficient for consumers, when IAEs are passed through.

Ofgem's position on IAEs, and on Transmission Use of Charging (TNUoS) effectively places the offshore wind generator as an insurer of last resort for the OFTO. This concerns us because:

- It is a significant change of policy that places unexpected costs on developers and generators;
- It reassigns risks and requires offshore wind generators to cover the cost of an asset and events that they have no control over, do not own, and do not have the opportunity or right to maintain or repair;
- It can deter new investors from entering the offshore wind market, driving up financing costs for offshore wind developers;
- The appropriate mechanism to handle these types of risks on regulated assets is for them to be socialised;
- It is inconsistent treatment between the onshore TOs and the OFTOs and will discriminate against offshore wind generators;
- Any deductibles determined by Ofgem need to proportionate to the asset size ;
- The proposals may incentivise insurers to avoid providing insurance and/or drive up the cost of insurance, which could lead to consumers paying more.

Unexpected costs for offshore wind generators

Ofgem's decision to make offshore wind generators an insurer of last resort for the OFTO represents a policy change that current offshore wind generators would not have been able to reasonably foresee and would not have budgeted

for. When the OFTO framework was set up there was no expectation that offshore wind generators would act as an insurer of last resort, and as we set out below, there are valid reasons why we would not have expected to be forced to act as one. A policy change of this type is retrospective; offshore wind generators have been built and developed on the reasonable expectation that they would not be acting as an insurer of last resort.

Reassignment of risks and appropriate mechanisms to cover them

The general regulatory treatment of risks is that risks should sit with the party that is best placed to manage them. The OFTO is the owner of these assets and responsible for their operations, maintenance and repair. When they tender for these assets, they perform due diligence and are aware of the risks they take on. Naturally they should be in the best position to manage these risks. However, the design and set up of the OFTO regime raises complications. Firstly, as a regulated utility, OFTOs are incentivised to be thinly capitalised to drive cost reductions. This can make it difficult for OFTOs to handle unexpected one-off costs. Secondly, while the OFTO has bought assets from the offshore wind developer, including the risks and obligations, we recognise that Ofgem is concerned about how the OFTO may be exposed to risks that come from development and construction, such as potential uninsurable latent defects.

However, even if it is appropriate for some risks to not be carried by the OFTO, that does not mean the appropriate solution is to transfer these risks to the offshore wind generator. The offshore wind generator does not own the asset and is not responsible for its maintenance or repair. As a result, it is not in an effective position to manage or mitigate these risks. Therefore, Ofgem's current proposal to make the offshore wind generator an insurer of last resort unreasonably transfers risks from the OFTO to the offshore wind generator.

Accordingly, these risks need to be managed appropriately. The nature of these faults is that they are infrequent, and many of them could be unforeseeable or end up as uninsurable while being owned and maintained by a regulated company, the OFTO. As long as there is a regulated utility responsible for these assets, and these risks are appropriately unforeseeable and uninsurable, then the appropriate and cost-effective mechanism is for these costs to be socialised through the IAEs. Trying to cover these costs through other mechanisms, eg. by placing it on the offshore wind generator, will drive up their costs, and this in-turn will indirectly cause greater costs to consumers by driving up the costs of offshore wind generators.

Consistent treatment between onshore and offshore

As set out above, we view that the appropriate mechanism for these type of events is that they are socialised, as it will result in the overall lowest costs.. This is also aligned with how these risks are treated onshore. Through the RIIO price controls onshore TOs have various adjustment mechanisms that

function similarly to an IAE. However, Ofgem's view on how these costs are passed through is different. The costs of the onshore TO adjustment mechanisms are socialised through the charging framework so they impact all users of the transmission network. They do not target or impact any individual generators or demand users. Passing IAEs through to offshore wind generators will be anti-competitive and discriminate against offshore wind generators, effectively penalising those generators for being located offshore.

Costs of insurance and the £5m deductible / 30% limit

We appreciate Ofgem's efforts to find an appropriate balance between ensuring that OFTOs are protected from unforeseeable and uninsurable costs, and ensuring that the OFTOs have the appropriate incentives to efficiently procure insurance that protects them from the risks they can and should cover. However, we view that the combination of your policy of having the offshore wind generator act as an insurer of last resort, and prescribing specific deductible / claim limits will have risks and perverse outcomes, as you have identified in the open letter.

OFTOs procuring insurance requires both the OFTOs seeking to purchase the right insurance, and insurers being willing to sell insurance. There are several risks these policies could impose:

- Insurers will not insure any assets they consider high risk as they view 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;
- OFTOs may procure insurance, but not at sufficient or efficient levels to protect the bearer of the cost of the IAE.

Some of these outcomes are hard to avoid because of how the OFTO framework is designed, and highlight why it is unfair for offshore wind generators to cover costs that come from a framework where the party responsible for the risk, the OFTO, may not be able to handle those risks.

We would encourage Ofgem to consider whether the current deductible levels are appropriate, and aligned with what OFTOs currently seek in the insurance market. Further, we would encourage Ofgem to consider whether OFTOs can procure insurance that meets these requirements efficiently, and whether or not the most cost-efficient and socially efficient policy is to let these costs be socialised, subject to Ofgem's assessment.

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

As set out in our answers above on the benefits and costs, we view there are multiple unintended consequences that Ofgem has not fully considered, the main impact being the increased overall costs to consumers through increasing the costs of future offshore wind projects.

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

We view that Ofgem needs to take a holistic view of its policies and how that impacts the offshore wind sector, not just the OFTOs. There are four notable policies that we view need to be considered both now and in the future:

- The Contracts for Difference framework, and the competitive auctions offshore wind developers participates in;
- The Connection and Use of System Code (CUSC) and Security and Quality of Supply Standard (SQSS) provisions on outages and compensation;
- Charging provisions set out within the CUSC; and
- The OFTO framework.

Currently, 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.

Further, the provisions of the SQSS and CUSC lead to offshore wind generators not being compensated for any OFTO faults. The cost of an OFTO outage is disproportionately felt by the offshore wind generator, who stands to lose more of their revenue, both absolutely and as a percentage, compared to the OFTO. This provides a strong incentive on offshore wind developers to ensure any assets they procure and install are fit for purpose.

In addition, 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.

Finally, 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.

Requirements for future tenders

We would also like to take this opportunity to comment on Ofgem's proposed minimum protections for future tenders. Ofgem's imposition of requirements on these tenders will drive up costs for consumers. Further, placing explicit requirements on how offshore wind developers must contract and build their projects is explicit interference from Ofgem in a well-functioning competitive market. This is further unnecessary as the OFTO tenders are a competitive process, where each prospective OFTO bidder has the opportunity to perform due diligence and assess the contractual arrangements procured for each project. As we've also set out above, offshore wind generators are disproportionately impacted by OFTO outages and are more than sufficiently incentivised to ensure the OFTO assets are fit for purpose.

These requirements will also be problematic and unrealistic for many offshore wind developers. Firstly, we'll address the five-year warranties. Many of the current offshore wind developers will have already signed their EPC contracts, years in advance of the OFTO tender, and they will simply be unable to provide these warranties through their contracts. Further, they will not necessarily be compatible with the various contracting arrangements that are common and established in a global and competitive market.

The proposed requirements are not necessarily market standard, and we know from experience that not all suppliers are prepared or happy to offer such terms. Imposing requirements on the contract terms that are more onerous than suppliers could negotiate elsewhere will increase costs and potentially reduce the attractiveness of the UK offshore wind market at a time when there is significant market expansion and competition for the supply chain in other areas of the world.

Secondly, we'll address the proposed top-up contractual provisions. Any offshore wind developer holding a CfD will not have been able to price in these proposals and applying them through the tender rounds will be retrospective. Not all offshore wind developers will be able to issue parent company guarantees. This may mean that developers will need to seek insurance to cover an asset that could be deemed uninsurable. Very few insurers will cover these costs and premiums could be excessive, driving up the cost of offshore wind and the cost to consumers. The other option, a retention of 10% of the estimated transfer value, is extremely inefficient and requires the developer to tie-up a significant sum of money, which will increase costs overall.

Further, we would add that there are still significant areas where this policy needs to be further clarified. As currently set out we are concerned that it is open to interpretation and developers, OFTOs and companies in the supply chain will take differing views. Areas where we view there should be further clarification:

- The “10% of estimated transfer value” is potentially arbitrary, and you should consider whether it may be more appropriate to link it to contractual values;
- At what point does “handover” occur eg. the Take-over Certificate?;
- What contracts count as subsea export cable contracts;
- Where the OFTO retains 10% of the estimated transfer value, will the developer be allowed to recover that value with interest?

Charging Policy

We note that Ofgem is taking an inconsistent position on charging in their open letter. Ofgem initially states charging is determined by the terms of section 14 of the CUSC and not by the Authority. However, Ofgem later states that a large proportion of any IAE costs awarded will be passed through to the relevant offshore generator in any event.

This is not what is currently set out in the CUSC. The CUSC is vague on how changes to an OFTO’s TRS impact the charges faced by an offshore wind generator. National Grid (NGET) has inappropriately issued a guidance note to add more detail on how these charges may feed through to an offshore wind generator. The requirements of Standard Licence Condition (C5) set out effectively that the charging methodology must be clear, and explicit. NGET can’t and should not be using guidance notes that are not within the CUSC to add more detail to a charging methodology.

Ofgem is the ultimate decision maker for any modifications to the CUSC, and as we highlight above, you should take into account that your views on the OFTO policy should be consistent with how Ofgem sees the CUSC. However, this should not override the change and governance processes the CUSC operates under.

If you have any queries on our response please feel free to contact me (almos@orsted.co.uk, 078 0759 2034).

Yours sincerely,

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