

## Ofgem's consultation on Income Adjusting Event policy in Offshore Transmission Licenses

RenewableUK response

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RenewableUK is the trade and professional body for the wind, wave and tidal energy industries. It promotes the deployment of clean energy in a smart energy system, by making politicians, the media and the public more aware of the UK's transition from fossil fuels to renewable sources. Formed in 1978, and with more than 400 corporate member companies, RenewableUK is the country's leading trade association working on the future of the electricity system.

We welcome the opportunity to respond to the Open Letter on Income Adjusting Events ("IAEs"). This response has been compiled by RenewableUK with input from our membership. Our members employ a quarter of a million people and will invest more than £18.8bn in UK infrastructure between 2017 and 2021 – over 90% of which will flow to regions outside of London and the South East. In 2017, 28.8% of the UK's electricity was generated from renewable energy sources. 46% of this was generated by onshore and offshore wind, which provided 13.2% of the UK's electricity needs.

### General Observations

Ofgem's Open Letter sets out the regulator's statutory objective of protecting the interests of consumers. We are concerned that in focusing on the impact of income adjusting events (IAEs) on the offshore transmission license holders ("OFTOs"), and not considering the wider impact of policy on the offshore developers, Ofgem is missing an opportunity to truly minimise costs to consumers. As this response will make clear, developers and offshore wind farm owners will be heavily impacted by the proposed changes, and this has the potential to increase costs of development and ultimately costs to consumers. Narrowly focussing on the IAEs and OFTO risks will have unintended consequences for the consumer. For example, some of the proposed changes are retrospective, affecting projects completed or already in construction or under development, effectively making them the "insurer of last resort". Such action raises concerns for future project and changes, increasing project risk and consequently cost.

Ofgem should therefore consider an alternative way to pass-through costs which are "uninsurable" to reduce costs to the consumer. If IAEs, subject to cost scrutiny and post-OFTO deductible being applied, were then passed-through into wider TNUoS then this would avoid 'perceived risk' being costed into projects by OFTOs or generators. This would result in costs only being passed-through to the consumer in the rare event of an IAE, rather than the consumers paying for the risk-added value (for example through higher CfD bids). Generators are already incentivised to build robust assets as they are dependent upon them in order to export electricity. Ofgem should ensure that OFTOs are incentivised to procure and keep comprehensive insurance to protect consumers from increased generation costs related to risk perception. Ofgem's statement in the consultation 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) is responsible for approving or rejecting code modifications.

The OFTO regime is 9 years old in 2018. Five tender rounds for OFTOs will be complete by the end of 2019. At its inception, Ofgem committed to a review of the regime, and with further CfD auction rounds coming forward, and the implications that this has for risk and financing, it is now an appropriate time to conduct a critical assessment of the success and learning opportunities of the regime, and its long-term future, and how lessons learned could build an even more robust and efficient regime. 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.

Should Ofgem decide to progress with making changes ahead of a more holistic review we ask that the following points are considered in particular:

- How wind farm developers acting as ‘pseudo-insurers’ risks affect investor certainty in the offshore wind industry in the UK. We also do not agree that this policy is the best outcome for the consumer.
- Retroactively applying policy to projects in TR5 is damaging to those projects. Ofgem’s policy for future OFTOs should not apply until TR6 at the soonest, and not effect contracts already signed.
- We support a deductible being applied to “uninsurable” events. Ofgem’s proposals seem reasonable at £5m or 30% of the cost (whichever is higher). However, Ofgem should also bear in mind the value of the entire OFTO asset, as well as the value of the claim itself.
- All pass-through costs as a result of IAEs should be scrutinised to ensure the OFTO carried out repairs in an economic, efficient and reasonable fashion. Allowed and disallowed costs must be transparent to the party to whom the costs are passed in order that they may challenge these where they see fit.
- OFTOs must be able to demonstrate to Ofgem that operation & maintenance (O&M) is ongoing and has been undertaken since the time of asset transfer in line with good industry practice.
- Ofgem should consider whether pass-through costs from IAEs are best passed-through to Wider TNUoS rather than Local TNUoS as this could lead to the consumer being better off overall.

**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?**

IAEs pose a risk to OFTO asset owners, and it is important that this risk is managed effectively, in the least cost way to OFTO license holders, developers and ultimately consumers. The Open Letter aims to address how risks are mitigated and allocated across OFTOs and developers. Our greatest concern is that at present and under these proposals, the allocation of risk is stacked unfairly against offshore windfarm owners. They bear the full risk of the OFTO asset failures, firstly through loss of transmission connection, and generation revenues, and secondly, they must also bear the costs of repairs, while having no ability to minimise these risks through asset management.

The Open Letter states that the licence provides “insurance of last resort”. The reality is that in the case of IAEs, it is the wind farm developer/owner that provides this insurance, following the publication of NGET’s guidance of 27th July 2017<sup>1</sup>. Placing the costs of this risk on offshore wind farm owners, while they are unable to control or mitigate the risk, could increase costs of offshore

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<sup>1</sup> NGET, 27<sup>th</sup> July 2017, “Reflecting variations in Offshore Transmission Owner (OFTO) revenue in Offshore Local TNUoS Tariffs” [https://www.nationalgrid.com/sites/default/files/documents/Reflecting%20variations%20in%20Offshore%20Transmission%20Owner%20%28OFTO%29%20revenue%20in%20Offshore%20Local%20TNUoS%20Tariffs\\_v2\\_0.pdf](https://www.nationalgrid.com/sites/default/files/documents/Reflecting%20variations%20in%20Offshore%20Transmission%20Owner%20%28OFTO%29%20revenue%20in%20Offshore%20Local%20TNUoS%20Tariffs_v2_0.pdf)

wind generation as all developers may act to protect themselves against an event that will ultimately only impact a small sub-set of projects. It is not clear therefore, that the proposal will result in the best outcome for consumers.

The Open Letter proposes using the HM Treasury guidance on the *Standardisation of PF2 contracts* as the basis for defining what can be considered uninsurable. While we broadly agree that an asset could be considered uninsurable “where the cost of insurance is deemed not to be value for money or is unavailable/excluded in the marketplace”, the comparison with the PF2 regime is not as clear as the Open Letter suggests. 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 Offshore Wind Generators who have not made a conscious decision in this regard. Furthermore, this policy is in effect now, where the premise for this is Ofgem’s decision regarding GyM SSEC2.

The IAE process should incentivise OFTOs to make efficient, timely and cost-effective repairs before they become IAEs or “uninsurable” events. We support Ofgem’s approach that all OFTOs should have LEG3 insurance cover as a minimum and 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. A deductible applied to the IAE condition would make managing “uninsurable” events more like insurance and should help to encourage OFTOs to carry out economic and efficient. The level proposed is a good starting point for consultation (£5m or 30%, whichever is higher), though it should also bear in mind the value of the entire OFTO asset, as well as the value of the claim itself.

As it will be the developer that ultimately covers the costs of the repairs and IAEs there should be a formal route to challenge the costs which are passed-through that the developer does not feel are reasonable, economic and efficient. Full cost breakdown for any corrective works should be made available to the relevant third party, to facilitate transparency. Similarly, it is vital that these costs are properly assessed and scrutinised in a similar way that developer costs are scrutinised ahead of asset transfer from developer to OFTO. The consultation contains no proposals to introduce a robust cost assessment process. There are cases where offshore wind generators have offered OFTOs asset management proposals to ensure proper maintenance of the assets, which are frequently rejected by OFTOs despite being offered at significantly lower than market rates or even for free. This aspect of the transaction has not previously been subject to any scrutiny or involvement from Ofgem. In these circumstances it seems unfair to then expect the generator to pick up a high bill later. 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.

In addition to our points about the costs of the actual repair, timeliness of repairs is also crucial for generators as time which is lost when the OFTO asset is unable to export electricity means that the generator bears the significant costs of lost generation.

The Open Letter proposes minimum protections that developers should offer to OFTO licensees. It is not the role of the regulator to involve itself in the commercial arrangements of either the developers with their contractors, or between developers and the OFTOs. Warranties are already provided, and we ask the regulator to therefore explain why existing provisions are not good enough.

Cable manufacture and laying is a complex process, therefore mandating a warranty to the OFTO faces several challenges. There are many different companies playing a role in the cable laying process. It is not clear how an Ofgem-defined warranty could be guaranteed on every project, or how “matching” warranties could be provided by each of the cable layers and suppliers. It could then fall to the developer to provide a warranty or make up the gap between the warranty offered and that which Ofgem demands at their own cost. Furthermore, there is often a period between the completion of the cable project and the handover of the assets to the OFTO – Ofgem will need to consider how and whether this period should be considered in the mandated warranty. Ofgem proposes a minimum warranty/ indemnity provisions as part of the IAE policy. It will be important for Ofgem clarify the circumstances in which it envisages protection over and above the “minimum” may be required and what it considers any such increased protection may consist of.

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

The regime should encourage OFTOs to seek the most comprehensive insurance available on the market, and once procured, to keep that insurance. Ofgem has appropriately identified that the IAE changes could drive OFTOs and insurers to not seek or not provide appropriate insurance for latent defects or “bad risks”. Ofgem needs to monitor whether these changes to the IAE limbs do drive efficient behaviour and minimise costs for consumers, not just OFTOs. Furthermore, insurers would expect OFTOs to pursue warranty providers, whereas it is unclear whether, in a non-insurance IAE situation, Ofgem would require evidence to substantiate that this has been pursued properly. This further loads the balance of risk onto generators. Having provided a warranty for five years for example, under these proposals, the wind farm owner would still be responsible for covering the cost of any IAE, whether through warranties, or through the current charging regime.

If the solutions proposed in the Open Letter are to be pursued, there will need to be some clarification of points and definitions to ensure a common and consistent approach across industry:

- The Open Letter makes references to both cables and assets. Ofgem needs to be clear where they are referring solely to cables (as in the case of the warranty proposals) or the entire offshore transmission asset (for application of the IAE policy as per the licence condition?). If cables are the regulator’s concern, will other assets be excluded? We suggest that each case is assessed upon its own merits and ask Ofgem to make a statement that specific cable failures do not set precedents for all future cable failure issues which may have entirely different root causes.
- How is “first event of asset failure defined”? This could refer to a specific failure of a type of cable across the whole industry, or it could refer to the specific failure of one specific cable at one wind farm for a specific reason. We believe the latter is more appropriate at a high level than the former. Following the failure of a cable type, it is possible that other OFTOs with a similar cable will not be able to secure insurance.
- The definition of “uninsurable” must be clear and robust; “exceptional circumstances” on page 5 will also require defining. This is an area of obvious concern for the potential to create unintended consequences. The IAE policy around “uninsurable” must require that OFTOs which believe they may be dealing with an “uninsurable” situation provide robust evidence of such before any pass-through of costs (less deductible). This includes providing evidence that insurance was unavailable in the market in line with the definition.
- Second events of failure should not automatically be considered IAEs. They must be assessed on their merits, whether “uninsurable” or not.
- Cable contracts generally foresee a handover at ‘sectional completion’ which is following the successful installation. Contracts will each have their own definition of the handover process. We would therefore welcome some more detailed drafting of “Handover of completed assets to Developer” 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.

- It is not possible for developers to retroactively procure insurance cover for projects in TR5 (which are under construction). Insurance contracts are already in place, and the insurance market will not allow projects that are in construction or post-construction to amend their construction insurance policies.
- Does “Estimated transfer value” refer to Initial Transfer Value or Indicative Transfer Value?
- We suggest that the £1m value of the “STC threshold amount”, 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.

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

The Open Letter takes a narrow view of reducing the costs of OFTOs and it does not take a wide enough view of the range of issues that it will affect and play into.

First, it does not appear to consider the decision in the guidance from National Grid ET of 27th July 2017 on the charging of income adjusting events to the wind farms TNUoS charges. This will have profound effects on the way developers design offshore transmission assets, and how wind farms are financed.

Second, it is essential that Ofgem recognises that if offshore wind farm developers are required to act as “insurers of last resort” for OFTOs through IAEs, this will be seen as a retrospective regulatory change and will drive up the costs of future offshore wind farms and the costs to consumers.

Third, the competitive CfD process has been very successful in driving developers to find the most cost effective to the development of the offshore transmission network, while incentivising them to ensure that it is robust. There is therefore questionable need for Ofgem to be mandating requirements on developers, particularly in relation to existing construction contracts and regulate a market that is arguably is outside of Ofgem’s remit.

Finally, as stated above, the OFTO regime is coming up to 10 years old. Ofgem committed to a review of the regime at its inception. With further CfD auction rounds coming forward, and the implications that this has for risk and financing, it is now an appropriate time to assess the future of the regime.