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14<sup>th</sup> March 2018

***Sent by email only to offshorelicensing@ofgem.gov.uk***

Dear Kate,

**CONSULTATION ON INCOME ADJUSTING EVENT POLICY IN OFFSHORE TRANSMISSION LICENCES**

Thank you for the opportunity to respond to the above consultation of 6 February 2018 (the “**Consultation**”). ScottishPower Renewables (SPR) welcomes in principle Ofgem’s efforts to further clarify and formalise the policy in relation to Income Adjusting Events (“**IAEs**”), and to define the limited circumstances in which these events should be allowed under the OFTO licence terms.

However, we have a significant number of comments and points on which we would welcome clarification. These are set out in our answers to Ofgem’s open letter questions, in the Annex to this letter. Our main points are summarised below:

- We believe Ofgem’s assessment of providing “uninsurability” protection through the IAE term is sound. Providing this protection avoids the situation where OFTO licensees need to price in the risk of uninsurable latent defects via a contingency fund – and where they benefit from a windfall gain if the event never happens.
- Offshore wind generators are already strongly incentivised to ensure the development and construction of good quality transmission assets; if the transmission assets become unavailable, the offshore wind farm is unable to transmit electricity and the generator incurs significant generation losses. Given the risks faced by offshore wind generators (post OFTO transfer), a number of generators have offered to carry out the O&M of the sub-sea cables to seek to minimise the risk of sub-sea cable failure. However, we understand such offers are frequently declined as the OFTO is unwilling to pay for the standard of service proposed. We believe this option should be reconsidered in the context of Ofgem’s proposals, if offshore wind generators are to be required to accept increased risk of cable failure in addition to the generator losses referred to above.
- In our answer to Ofgem’s Question 1 of the Consultation, we have a number of points covering the following areas:
  - i. Minimum protections and Warranties

- ii. Requirement of the generator to “top up” contractual protections which fall short of the minimum requirements, and
  - iii. The interface with the LEG3 insurance cover which Ofgem states the OFTO will be required to maintain.
- We disagree with Ofgem’s proposal that minimum contractual protections should be active for all future (TR5 and beyond) OFTO tenders. We note that East Anglia One will already have placed its key contracts and will have minimal scope to re-open them to include such protections. We provide further justification on this in our answer to Question 2.
  - We note that there is no existing obligation on OFTOs to discuss potential failures with the developer or any information on the status of the OFTO assets. If the developer’s insurers are expected to provide cover, they will expect to have the right to be able to step in to carry out a pre-emptive repair. Issues could present themselves if it is found that the OFTO had early indications of a failure and did not pass this knowledge on.

Again, we thank you for the opportunity to respond to this Consultation and would welcome you to contact me if you require any clarification on anything contained above or in the annex to this letter.

Yours sincerely,



Joe Dunn  
Grid & Regulation Manager  
ScottishPower Renewables

## ANNEX

### **1. Do you agree with our assessment of the benefits and risks of existing IAE policy and the proposal to formalise and strengthen it as suggested in the consultation paper?**

#### Benefits

Ofgem states that the principal benefit of providing “uninsurability” protection through the IAE term is that future OFTO licensees need not price in the risk of uninsurable latent defects. This appears a sound assessment, and would avoid OFTOs benefiting from a windfall gain if they held a contingency fund for an event that never happened – it would be unfair for the generator to bear this cost (through increased TNUoS charges).

Furthermore, whilst the risk of OFTOs including contingencies in their bids is a real one, we also consider that the inclusion of specific contractual caveats for asset failure in OFTO bids could provide a further “back door” for recovery of these types of events. We would welcome confirmation that any formalised IAE policy will specifically exclude these types of caveats being included in OFTO bids.

It is clearly in the interests of generators and consumers that IAEs, and the costs associated with them, are kept to a minimum. To this end, particularly in generator build scenarios, we believe there would be merit in the relevant generator being involved in the IAE determination process and being given the right to make submissions, e.g. on whether the event in question is, indeed, uninsurable.

#### Impact

We would note that generators will be exposed to additional costs should an IAE be accepted post warranty period, and generators are likely to need to include provisions in their CfD bids against the possibility that such events might occur. Such costs would ultimately be borne by the consumer.

#### Risk allocation

Offshore wind generators are already strongly incentivised to ensure the development and construction of good quality transmission assets; if the transmission assets become unavailable the wind farm is unable to transmit electricity, and the generator will incur significant generation losses. In view of these risks, a number of offshore wind generators have offered to carry out the O&M of the sub-sea cables to seek to minimise the risk of sub-sea cable failure. We understand that such offers are frequently declined despite being often made at below market rates, in part we understand because an OFTO is unwilling to pay for the standard of service proposed.

This aspect of negotiations between the offshore wind generator and the OFTO has not previously been subject to any scrutiny or involvement from Ofgem. We would consider it prudent for Ofgem to revisit its approach if offshore wind generators are to be required to accept increased risk of cable failure in addition to the generator losses referred to above. The type of increased oversight a generator would have if it were to carry out the O&M services on the OFTO assets would serve to provide it (and its insurers) greater comfort, as it would allow greater foresight of developing issues and control over their management and mitigation. Perhaps as an absolute minimum generators should be able to carry out the O&M during the warranty period.

### Minimum protections

In respect of the minimum protections that Ofgem is proposing, developers should offer to OFTO licensees, there are a number of areas where we would welcome clarification:

- Are there any circumstances in which Ofgem envisages protection over and above the 'minimum' protection would be required?
- Will the value of the indemnity at option 2(a) be calculated by reference to the same methodology as in 2(b) i.e. 10% of the estimated transfer value? Is it the transfer value of the cables only, or the complete OFTO assets, and is it proposed that this is an annual amount or in aggregate over the suggested 5 year period?
- Option 2(a) proposes that the 'top-up' indemnity to be provided by the generator must be backed by a rated security of parent company guarantee. In our view an alternative security for this could be an insurance policy where the developer has purchased a guarantee maintenance provision within their Construction All Risks (CAR) policy. Would this be an acceptable alternative?
- It is not clear what OFTO assets the minimum protections are designed to include. We understand that it is just in relation to sub-sea cables, as this is the direction of the Consultation, but it would be helpful if Ofgem could confirm this as it makes a crucial difference with respect to the level and scope of insurance that will need to be procured.

### Warranty from the Developer

We would request some further clarifications with regard to the proposed warranties, specifically:

- Can Ofgem confirm that the requirement for warranty cover for "*costs of repair and replacement of sub-sea cables*" is only where, and to the extent that, such repair and replacement is necessary as a result of a latent defect in the sub-sea cable (i.e. not as the result of, eg damage caused by a third party, fair wear and tear or a failure of maintenance by the OFTO)?
- To the extent there are any latent defects in a sub-sea cable (or any transmission assets) at the time of the OFTO transfer, the risk of such defects will have been taken into account by the OFTO in its pricing and/or in other risk transfer provisions between the parties. We assume there will therefore be a need to align with any latent defects protection and ensure the OFTO isn't able to obtain double recovery?

### Top Up from the Offshore Generator

The "top up" obligation is stated as necessary to give the OFTO "the overall contractual protection that is equivalent" to the contractor warranty requirement. As such we would welcome confirmation that the offshore wind generator's "top up" liability:

- should only cover costs of repair/replacement to the extent the same would have been covered by the contractor under a market standard warranty (should such a warranty have been in place), and not lost income/profit/revenue etc;
- should be only for the additional period necessary to reach the 5 years from handover (if any);

- should not be an indemnity – the contractor's warranty is likely to be included in a defects notification provision, which will entitle the contractor to rectify the defect at its own cost rather than paying for the OFTO to engage a third party to do so (which is likely to be more expensive). As such this should also be the extent of the offshore wind generator's liability;
- should (where it is to be backed by rated security or parent company guarantee) be subject to the same limitations as the contractor's; and
- should not be given effect by way of retention – this is not usual practice and the OFTO licensee is unlikely to be able to provide a robust rated security or parent company guarantee to prove the offshore wind generator with comfort in relation to any such retention.

### OFTO LEG 3 Insurance

The interface between the minimum protections offered by the developer and the minimum insurance cover which Ofgem states the OFTO will be required to maintain is unclear:

- If the OFTO can obtain LEG3 insurance, is the contractual protection still required or could it be limited to the deductible under such insurance? There should be no ability for double recovery on the part of the OFTO, and if the costs of such insurance have been priced into the OFTO's bid, the offshore wind generator should not also be required to provide contractual protection.
- Will the OFTO be required to take out Business Interruption Insurance? As stated above, the contractual protection required to be provided should be limited to repair costs and not loss of income (as such, losses would not be recoverable from a contractor under its warranty).
- Can Ofgem confirm that they consider that if LEG3 insurance becomes unavailable, from time to time, that this means the cables have effectively become uninsurable?

We would welcome confirmation from Ofgem on these issues.

## **2. Do you consider that there are likely to be any other unintended consequences of implementing the proposed IAE policy as suggested in the consultation paper?**

We note that Ofgem considers that the minimum contractual protections proposed are to be active for all future OFTO tenders (for TR5 and beyond.) We do not agree that this should be the case, as projects in this category, for example, East Anglia One, will already have placed their key contracts and will have minimal scope to re-open them to include such protections. Insurance will also have been purchased.

Retrospective changes will put such generators at an immediate disadvantage and invite additional risk and cost. It would be particularly difficult for generators to insure against the type of protections suggested, particularly if such insurance had to be procured/amended retrospectively, as options in the market will be considerably more limited. The exact level of these costs will be determined by the scope of the assets to which these minimum protections apply (for which we have requested clarity above). Naturally for future projects, there would be more scope for warranties or insurance protection to be negotiated in advance (assuming a reasonable position is reached on the minimum protections proposed) when prospective contractors or insurers are competing for contracts.

If Ofgem were to require developers to provide a 5-year indemnity, developers would have to look to manage this risk, most likely by way of insurance. However, to satisfactorily manage such a lengthy indemnity, 60 months' guarantee maintenance cover would need to be purchased with the CAR policy. Currently only 24 months is typically available, and there is little or no appetite within the insurance market to provide longer cover. If insurers can be persuaded, then cover is costly and could increase CAR costs significantly. If insurers have knowledge of this requirement, it could drive prices higher still.

We are mindful that Ofgem has yet to propose a workable OFTO build model, and we would suggest that consideration should be given to this, particularly around how such IAEs would be dealt with under such a model.

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

There is no existing obligation on OFTOs to discuss potential failures with the developer or any information on the status of the OFTO assets. If the developer's insurers are expected to provide cover, they will expect to have the right to be able to step in to carry out a pre-emptive repair. Issues could arise if it is found that the OFTO had early indications of a failure and did not pass this knowledge on. The result could be that cover is withdrawn for future projects, precipitating the risk of the assets becoming uninsurable. We therefore believe it is in the interests of the developer to ensure that any indications of failure are transparent and known to all parties.

As noted above, if the developer is obliged to provide the proposed minimum protections to the OFTO, further consideration must be given to giving the developer a right to carry out the O&M services. Generally, this is a pre-condition to a manufacturer granting a warranty, and the warranty will fall away if a repair is carried out by anyone else. For example, a solution may be that the OFTO has to accept the developer bid for O&M services (if it is offered) within certain parameters.