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Dear Akshay

Open Letter: Consultation on Income Adjusting Event policy in Offshore Transmission Licence

We welcome the opportunity to provide our views on Ofgem's proposals to amend the existing Income Adjusting Event (IAE) policy as outlined in the offshore transmission licence¹.

We agree with the intent behind Ofgem's proposals where further clarity is provided on the IAE policy and a formal basis for Ofgem's decisions in this area is established. However, it is important to ensure that any changes to the existing policy appropriately allocate any residual risks. In this respect, Ofgem's proposals outlined in the consultation seem to exclusively penalise offshore generators as developers of the offshore transmission infrastructure. We also note that, while Ofgem is consulting on the elements of the IAE policy, no formal assessment of the offshore transmission regime has been done since its full commencement. It is our view that incremental changes to the IAE policy, without a full impact assessment, might result in unintended consequences and ongoing retrospective changes to the policy in the future.

Separately, we are concerned about the lack of clarity around IAE cost recovery through transmission charges. Ofgem's approach taken in the Targeted Charging Review suggests that charges broadly fall into 'forward-looking' and 'residual' which, respectively, incentivise the efficient use of the network and recover the residual costs of the system not attributable to a specific system user. Applying this logic, offshore generators already pay local charges reflective of their connection to the system. Given that the costs arising from IAEs are not attributable to a specific generator's behaviour, a suggestion that these costs should be

¹ Amended Standard Condition E12–J3: Restriction of Transmission Revenue: Allowed Pass-through Items



recovered from an offshore generator does not tie in with Ofgem's overarching policy on charging. We require that further clarity on this is provided by Ofgem.

In terms of Ofgem's specific proposals, it would be hugely challenging for developers to retrospectively procure additional insurance on projects which have already started construction or are in operation. The suggested change in approach offers many challenges from an insurance perspective, both in terms of cover and cost, in an already challenging market. Taking these into consideration further in depth analysis and review is required.

Finally, given Ofgem's intention to rely more on the discretionary assessment of the future IAE claims, we would welcome a consolidated guidance document formally outlining Ofgem's approach applied when assessing these claims.

Our detailed views in response to consultation proposals are outlined further in this document. If you have any questions in relation to this response, please do not hesitate to get in touch.

Kind regards,

Polina Kharchenko

Regulation Manager

Consultation questions

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?

We note that developers are already incentivised to deliver offshore transmission infrastructure of high quality and standards in the most cost effective and efficient way. This is done through the OFTO cost assessment framework, reputational incentives and also developers' direct commercial exposure to any issues arising on the offshore transmission link. In contrast, it remains unclear whether the current regulatory framework provides a sufficient onus on OFTOs to follow the best practice approach while operating and maintaining offshore transmission assets over the 20-year licence period. For example, while the existing policy provides a route for pass-through costs for OFTO licensees, it does not incentivise efficient pre-emptive repairs at the most economic and efficient costs for the benefit of consumers.

We are concerned that Ofgem's consultation proposals seem to exclusively penalise generators as developers of the offshore transmission infrastructure. Transferring residual risks of operating offshore transmission infrastructure, such as the cost of uninsurable events or topped up warranties, onto offshore generators contradict Ofgem's 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." Placing the cost of these residual risks on offshore generators without taking account of the generators' ability to foresee and control these risks will result in increased costs of delivering offshore transmission assets going forward. We do not agree that the cost of uninsurable events in offshore transmission should be passed through to offshore wind farm generators through the IAE route.

In line with the above, with respect to transmission charging in the context of IAEs, we require more transparency on the charges that a developer is expected to face. Given that currently the cost of the offshore transmission asset over and above the Transmission Entry Capacity (TEC) of the associated generator is socialised, we require further clarity on the charging approach applied to IAEs and how this approach compares to the charging arrangements for similar assets and events in onshore transmission.

Overall, given that Ofgem's proposals might lead to a fundamental change of the IAE definition, it is our view that a more comprehensive assessment of the benefits and risks of the current IAE policy and implications of the proposed changes would be fitting at this stage.

Finally, if Ofgem decides to take any of the proposals forward, it would be hugely challenging for developers, which have already started construction or are in operation, to retroactively procure additional insurance or warranties on projects.

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

Uninsurability definition

We note that while Ofgem is consulting on the definition of 'uninsurability' for the purposes of IAE Condition, the consultation document does not formally set out what constitutes a 'latent defect' or 'latent defect risks', on the basis of which uninsurability would be assessed. Further clarity is also required on the range of the 'exceptional circumstances' that would result in 'the first event of asset failure' being deemed as uninsurable. Moreover, the 'first event of asset failure' noted in the consultation leaves ambiguity as to whether this event relates to the first failure on a specific offshore link or applies to the wider offshore transmission infrastructure.

It is our view that the suggested change in approach offers many challenges from an insurance perspective, both in terms of cover and cost, in an already challenging market and, therefore, further in depth analysis and review is required.

In line with the above, while Ofgem is consulting on a formal definition of uninsurability, we have not seen any formal assessment of the OFTOs-related insurance issues done by Ofgem or an independent consultant on behalf of Ofgem. Therefore, while Ofgem's proposal is based on its experience while dealing with past IAE claims, this does not necessarily provide a conclusive basis for developing a 'robust' uninsurability provision.

Warranties and indemnities

While there seems to be an expectation that OFTOs take on the risks associated with operating and maintaining offshore transmission infrastructure, based on Ofgem's proposals offshore generators are essentially expected to underwrite any residual risks not identified through the due diligence process prior to the offshore transmission asset transfer. We are concerned that any latent defects, beyond control or visibility of developers, arising in the first five years of the OFTOs' licence period, would result in direct costs on a developer as a result of Ofgem's 'topped up' warranty proposals.

Overall, Ofgem's proposal to intervene in very commercial aspects of the offshore transmission development regime is concerning. While developers have a certain ability to influence the supply chain negotiations, securing 5-year warranties can be very challenging for a developer procuring multiple smaller contracts for different parts of the project. Given that in some instances manufacturing guarantees do not extend beyond 3 years, obligating a developer to essentially underwrite any manufacturing or other risks spanning beyond the standard guarantee term leads to an unfair allocation of the costs of these residual risks.

Separately, it is our view is that an indemnity should be restricted to export cables only. We note that Ofgem's consultation proposals in respect to warranties and indemnities are

'minimum protections' that Ofgem expects developers to offer to OFTO licensees. We require further clarification on the circumstances that may result in these protections being over and above this 'minimum' level.

While we note Ofgem's proposal to oblige all OFTO licensees to procure, as a minimum, an Operational All Risk insurance policy with a LEG3 exclusion or equivalent, given recent insurance developments and no formal report issued by Ofgem on this, it is not clear what the 'Operational All Risk insurance policy' covers from an OFTO's perspective. Consequently, this leads to a lack of clarity on the magnitude of the uninsured residual risk that developers are getting exposed to. In addition, further clarity on how insurance protections and warranties would interact is required.

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

As noted earlier, a more formal assessment of the existing IAE policy and any benefits and unintended consequences of Ofgem's proposals would be appropriate at this stage. This would ensure that any amendments to the existing IAE policy are given a due in-depth consideration and the risk of ongoing retrospective changes to regulations, as new issues come to light, is eliminated. We also consider that the process for approving the IAEs by Ofgem could be made more transparent and suggest that Ofgem considers issuing a formal guidance on the IAEs assessment process.