

Kate Kendall  
Ofgem  
9 Millbank  
London  
SW1P 3GE

28<sup>th</sup> February 2018

Dear Kate,

**Consultation on Income Adjusting Event policy in Offshore Transmission Licences  
("Open Letter")**

I am writing to you on behalf of Transmission Capital Partners in response to the Open Letter dated 6 February 2018 which seeks to consult on the income adjusting event ("IAE") provisions in the offshore transmission licence, and particularly on the latent defect risk and uninsurability issues.

Our responses to your questions are as follows:

**Q1. 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 agree with your assessment that the IAE policy should provide protection for the OFTOs in case of uninsurable risks caused by latent defects. Consumers benefit from the low cost of capital available to the OFTOs. This low cost of capital is mainly derived from the perceived low risk profile of the assets which allows for more highly geared financial structures. These structures and the long-term inflation-linked fixed revenue stream of the OFTOs would make it very difficult for the OFTOs to hold the risk of commercially uninsurable perils. The main reasons are that:

1. At financial close, each OFTO will have defined insurance and contingency budgets which, considering their long-term inflation-linked revenue stream, cannot be increased in order to pay for major increases in insurance premia as a result of risks affected by losses relating to latent defects occurring during operations;
2. Under their financing terms, the OFTOs are not able to accept increased levels of deductibles as financiers demand certain minimum levels of insurance (both in terms of price and coverage); and
3. The insurance market for the OFTO sector is still relatively small and very sensitive when it comes to losses caused by the same or similar risks e.g. unforeseen cable failures caused by the electrical interaction between fibre optic cables and power cores.

We do not believe that there is any risk that OFTOs will not conduct thorough due diligence. As we are sure that you are aware, as part of the insurance procurement and placement process, OFTOs are obliged to make all material disclosures relating to the risk for which the

OFTO seeks insurance coverage. Therefore, if an OFTO does not follow a thorough due diligence process, it risks the relevant insurance policy being made void by insurers if it later becomes apparent that material information was available to the OFTO, but the OFTO failed to identify and disclose it to the insurers. We would anticipate the same principle to apply to the IAE protection afforded by the licence.

Furthermore, typical insurance deductible levels (which we think should be replicated by the IAE treatment of uninsured latent defects) are such that they would have a material impact on investor returns should an event happen. We believe this gives a strong incentive to an OFTO to ensure thorough due diligence at the outset.

We also agree that the definition of uninsurability as defined in the HM Treasury on PF2 contracts provides good protection for the consumers. However, considering the small size and specialist nature of the OFTO insurance market, we would suggest that the OFTOs shall approach “*the **relevant** insurance market with reputable insurers of good standing in respect of that risk*” rather than “*the **worldwide** insurance market [...]*”. In addition, we would suggest that the Authority accepts that approaching the relevant insurance market on a three-yearly basis, in instances where the OFTO holds a long-term agreement for the relevant insurance, would constitute “*regular intervals*” [we would like to keep this sentence confidential]. We also anticipate that pre-existing issues which are excluded from insurance policies by the underwriters at first inception (asset transfer) would be covered by the IAE policy relating to uninsurability.

We do not agree that setting a deductible at £5m or 30% of the claim is the right solution for the uninsurable claims. It is important to take into consideration that the earlier, and smaller OFTO projects, have deductibles set at much lower levels than £5m proportionate to the size of the project and revenue stream. Ofgem recognised that fact in setting the threshold level of the Income Adjusting Event under the applicable licence for those projects. Smaller projects would have significant difficulty to withstand a claim in an event whereby the claim is settled net of £5m or more.

We do not understand the rationale for proposing a deductible level at 30% of the level of the claim. As noted above, this would disproportionately impact the smaller OFTO projects in particular. This is not the way insurance works and would require the OFTO to assume, and make provision for, the inability to recover 30% of the worst possible claim. We are also not sure of the rationale for this or how it is proposed to be applied in practice. For example would it apply to the full claim value as submitted under the IAE policy, or to the fully adjusted claim value (for, in the Authority’s opinion, disallowable costs) under the IAE policy?

We therefore suggest that IAE claims relating to uninsurability are adjusted by the higher of:

1. The claimant’s current deductible at the time of the claim; or
2. The deductible which applied to the fully insured policy immediately before the relevant risk became uninsurable; or
3. The IAE threshold in the licence.

Such a solution would be fair and easily applicable across the OFTO sector as insurance policies are held on record by all OFTOs and their brokers, and therefore are easy to inspect at any time. In addition, the Open Letter states that “*the [HM Treasury] guidance emphasises that, to ensure effective risk management by the private sector partner, such a private sector partner should remain liable for **deductible related losses***”, a statement which supports our aforementioned proposal.

We agree that each claim shall be capped at the reinstatement value of the assets and shall be net of all commercial recourses applicable to the relevant claim.

We also agree that, as a minimum, a five-year warranty covering all repair costs shall be provided by the developers under all construction contracts. In fact, our experience of submarine cables shows that it is a standard practice in other sectors to procure a minimum of 10-year warranty for such cables and we believe it should be possible for the offshore wind developers to be able to secure similar warranties. We would suggest that the liability cap is based on either 10% of the estimated transfer value or 15% of the relevant contract value, whichever is higher. Although our preference would be for the warranties to start from the asset transfer date, we understand it may not be possible, and would accept warranties from the date of the relevant taking-over certificate.

Parent company guarantees are relatively difficult securities to enforce, and we would therefore recommend that indemnities are backed by letters of credit or performance bonds issued by credit rated counterparties and payable on demand. A retention mechanism is difficult to conceive of since financing for the asset transfer value is raised up front and would have to be sized for the full purchase price (or the OFTO would potentially be exposed to refinancing risk or break costs).

Our experience shows that it is possible for the OFTOs unaffected by the fibre optic issues to procure competitively priced property damage insurance in the current market ***without*** any LEG exclusions i.e. providing full coverage for defects arising from design, manufacturing and installation. We would therefore suggest that this is the target set for all property damage policies. Notwithstanding the above, if LEG3 is set as a minimum for all property damage policies, we would suggest that the wording of LEG3/06 is “hardcoded” in each transmission licence to ensure consistency amongst OFTOs. We have seen before that insurers and brokers may consider different versions of LEG3, all very similar to each other.

**Q2. Do you consider that there are likely to be any other unintended consequences from implementing the proposed IAE policy as suggested above?**

We do not foresee other unintended consequences from implementing the proposed IAE policy apart from those summarised in the Open Letter.

**Q3. Is there anything else that Ofgem should take into consideration when deciding on the future policy for IAEs?**

We would encourage the Authority to make the necessary steps in order to develop the OFTO regime towards the OFTO Built model. Allowing OFTOs to bear the procurement and construction risk for the OFTO assets would make the risk allocation for latent defects much clearer.

Please do not hesitate to contact me if any of our responses are unclear or require further elaboration.

Yours faithfully



**Dominik Adamus**  
Commercial Director