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Dear James,

Vattenfall response to OFTO Tender Process – Consultation for Future Tender Rounds

Vattenfall is the Swedish state-owned utility and one of Europe's largest generators of electricity and producers of heat. In the UK, we are strongly committed to significant growth in climate smart energy solutions, particularly offshore wind.

Vattenfall has invested over £3 billion in UK wind power since 2008 and, as of early 2018, we operate more than 1GW of installed capacity with more than 4GW of onshore and offshore wind in development over the next decade. Currently, the electricity export for two of our British offshore wind farms is managed by Offshore Transmission Owners (OFTOs): the 300MW Thanet wind farm (Thanet OFTO Limited) and the 150MW Ormonde wind farm (TC Ormonde OFTO Limited). As a result of this, and our development activities, we have gained extensive experience of the OFTO regime.

Vattenfall welcomes the opportunity to comment on the tender design process of future OFTOs, which will apply to our 1.8GW Norfolk Vanguard and Norfolk Boreas projects if we proceed. We argue in this consultation that Ofgem should adjust the focus of the tender process onto the technical adequacy of OFTO bids and away from price, as we believe long-term value for money for the consumer will be best realised through a process which emphasises technical competence in asset maintenance over the cheapest price on day one.

We also share Ofgem's concerns about over-consolidation in the OFTO market and the desire to introduce new bidders into the regime. However, we caution Ofgem against steps which would over-simplify the tender process as we are concerned that this will attract the wrong kind of bidder into a regime designed to cater for complex, high value, critical electricity infrastructure.

Finally, we reiterate the call made in our recent consultation response on Income Adjusting Event policy for an holistic review of the OFTO regime in 2018 to establish whether reform of the regime can maximise consumer benefit and ensure more equitable treatment for generators.

Yours sincerely,



Piers Guy
UK Country Manager, Vattenfall Wind Power Ltd

Annex A – Detailed consultation response

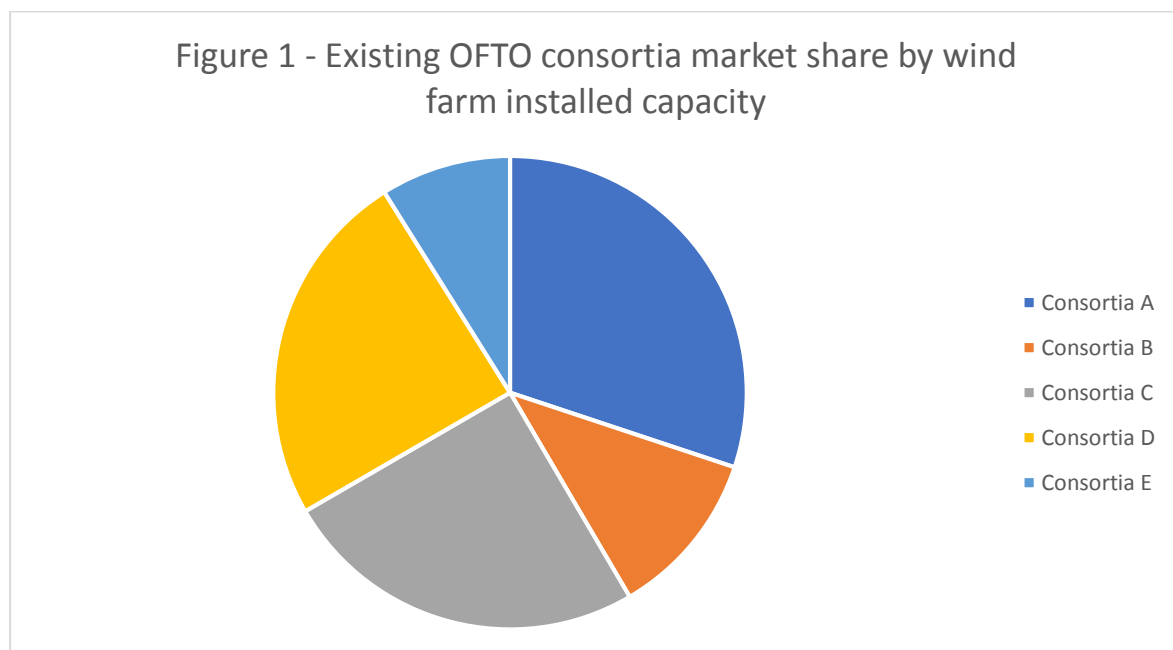
1. Have we identified (in chapter 1) the right drivers for possible change to the OFTO tender process? Are there other drivers for change we should consider?

Vattenfall agrees that Ofgem has identified four valid drivers for change in the OFTO tender process. We have reproduced these as points (a) to (d) below and have noted remarks as follows:

a. A more mature bidding market;

Ofgem cites concern in the consultation around ‘over-consolidation’ in the OFTO market. Vattenfall shares this concern and Ofgem’s interest in improving the quantity and quality of OFTOs bidding in future tender rounds.

Figure 1 below shows that there is already significant consolidation within the OFTO market: of the 15 existing OFTOs, these are owned by five consortia comprising seven unique ultimate controlling companies. Furthermore, three of these consortia control 80% of the OFTO market and, of the seven OFTO ultimate controlling companies, two ultimate controlling companies account for nearly 50% of the market.¹ This compares with a more diverse offshore wind generation sector where 32 operational offshore projects are ultimately owned by 29 unique companies.



Source: Vattenfall analysis

The evidence from the first three projects with announced shortlisted bidders from tender round five suggests that this trend is set to continue: of the eight proposed controlling companies only two have not previously held a financial stake in an existing OFTO.

¹ Measured by installed capacity of the wind farm served by the OFTO.

We therefore share the implied concern in Ofgem’s consultation document that there is a risk of insufficient competition in the OFTO tender process. We would also add to this a concern over how shares in OFTO consortia are divested and the process by which Ofgem oversees this. We are aware that Amended Standard Conditions E12-D2 of the OFTO licence (‘Equity Transaction Reporting Requirement’) requires notification to Ofgem of share transactions in OFTOs, however, this appears to be only a post hoc reporting requirement and we are unsure what powers Ofgem has to review these transactions to ensure that the new entities do not distort competition in the market through over-consolidation and ensure that they are fit-and-proper businesses to be major infrastructure asset owners.

Ofgem may wish to consider, as part of this consultation, considering its approach to equity transactions. This is particularly pertinent with regards to tender process policy given that KPMG’s investor perspective on the OFTO regime, available on the Ofgem website and prepared for GEMA, highlights that acquiring an equity stake in an OFTO after licence grant allows parties to ‘circumvent’ the ‘Ofgem run bidding process’ and this is seen as ‘attractive to investors’.²

Vattenfall strongly advises Ofgem not to either lower the entry requirements for OFTO tenders or shift further risk from OFTO to generator as a policy response to low levels of competition in the tender process or the eventual winners selected by the tender process.

b. Projects are becoming larger;

Vattenfall agrees that this is the likely direction of travel for ‘conventional’, new build offshore wind farms, particularly those further from shore than existing projects, which may be brought forward under future rounds. For example, Vattenfall has c.4GW of offshore wind under development at the time of writing and 3.6GW of this is made up of our Vanguard and Boreas projects, each of 1.8GW.

c. More infrastructure tenders from which to learn lessons;

This should, in particular, include an holistic view of the successes and failures of the existing OFTO regime. This should not just be limited to the pros and cons of different tender processes, but also the policy outcomes that have been secured, both good and bad. Vattenfall has called for an holistic review of the OFTO regime in its response to the recent OFTO Income Adjusting Event (IAE) consultation.

d. Recent contractor solvency issues.

Ofgem raise this issue with respect to the recent insolvency of Carillion. Vattenfall shares Ofgem’s view that it would be prudent to consider ways in which OFTO bidders can demonstrate they are sufficiently financially robust to own and operate complex and critical transmission assets over a 20 year period, particularly with reference to the trend identified in (c) above.

Ofgem’s recent policy consultation on IAEs proposed to respond to the risk of ‘thinly capitalised’ OFTO entities not realising their tender revenue stream bids by re-allocating financial risk from OFTOs to generators. As we responded in that consultation, we think that there are more

² KPMG, *Offshore Transmission: An Investor Perspective – Update Report* (Jan, 2014), p.37.

appropriate, equitable ways to address this with lower risks of unintended consequences and changes to the tender process may reduce the risk of contractor insolvency.

2. Are the objectives of our review appropriate? Are there any other objectives that we should consider?

Vattenfall believes a broader and holistic review of the OFTO policy, nearly 10 years since its introduction, would be welcomed by generators and OFTOs alike. This would be preferable to a process of incremental change and a mixture of policy consultations and open letters which risk being disjointed. This would also align the OFTO process more closely with the consultations which frame RIIO for gas and electricity onshore transmission and distribution.

A further review should also consider within its remit:

- Whether the balance of risk is skewed too far in favour of OFTOs and the extent to which that leads to unintended consequences, such as inadequate preventative maintenance regimes;
- How allowed rates of return for OFTOs are kept in line with market expectations and aligned with the policy considerations of RIIO-2;
- The relative importance of absolute bid price and value for money in selecting preferred bidders. Vattenfall is concerned that these two concepts are confused in OFTO policy and it may not always be the case that the cheapest bid is the best value for money for the consumer in the long-run;
- How the OFTO regime encourages innovation in offshore transmission

Vattenfall notes the reference in Chapter Two of the consultation to ‘initial feedback from the market’ on tender process. It is apparent from the consultation document and our experience as a generator that feedback has been gathered from the OFTO bidder community and not from developers who are forced to participate in the asset sale.

This is important as it is apparent that the consultation, and Ofgem’s early thinking, has been shaped substantially by those with a vested interest in a certain policy outcome and not from a broad section of society, including representatives of consumer groups.

A key piece of bidder feedback apparent in the consultation is that the OFTO tender process is a time-consuming one. Whilst we generally believe that reduced complexity and administrative burden in the market is a good policy aim, we firmly believe that OFTO tender processes should be proportionate to a market worth over £2bn in tender round five and providing a critical service to both generator and consumer.

Finally, we believe there is a strong case for improving the coverage and efficiency of OFTO maintenance regimes. Vattenfall is concerned that OFTOs may be under-resourced for their maintenance requirements and that there is a risk that the financial backers of OFTOs are unwilling to make the necessary investments to ensure long-term asset efficiency. We believe this could be solved in three ways:

- i. Ofgem introducing an independent technical audit of transmission asset operation and maintenance, on an annual basis, which provides assurance that OFTOs are meeting good industry practice;
- ii. Sharpening the availability incentive so that there is reduced risk of under-investment and quicker resolution of any issues that arise; and
- iii. Ofgem advertising in tender rounds that they expect a much greater focus on technical track record, which may encourage more partnerships between engineering and construction companies and finance companies.

3. With respect to the existing tender process arrangements:

(a) Are any different or additional arrangements needed to mitigate the risk of OFTOs not being financially or operationally robust?

(b) In particular, do you consider that our tender process would be robust to a Carillion-type scenario? Are there additional questions we should ask at EPQ or ITT?

(c) Do you have any other specific feedback on the existing tender process?

Vattenfall believes that the financial robustness of OFTOs could be improved by requiring a greater financial link between the OFTO Special Purpose Vehicle (SPV) and its financial backers. Most or all existing OFTO controlling companies appear to be significantly well capitalised entities but our understanding is that, at the moment, controlling companies are able to exit OFTO arrangements with little consequence if an OFTO was to fail. In this context, we note the parallel in Ofgem's Independent Distribution Network Operator (IDNO) policy, where IDNOs are required to hold collateral in escrow or the controlling company must supply a parent company guarantee.

We also believe it is important to improve the diversity of OFTO controlling companies active in the regime (evidenced above) to prevent the spread of contagion if one of these companies was to suffer financial difficulties.

Finally, Ofgem may wish to introduce a 'gate check' prior to any sale of an OFTO stake to ensure that the incoming party is sufficiently robust to financial failure.

With regards to the operational robustness of OFTOs, we have offered policy options elsewhere in this consultation response which include:

- Placing greater focus on O&M activities in the materials that Ofgem uses to 'market' the OFTO regime to investors. This could also be supplemented with consideration of how and where Ofgem advertises the regime;
- Requiring OFTOs to submit to Ofgem an independent technical audit of their O&M regimes; and
- Sharpening the availability incentive to make lack of availability a more punitive event for OFTOs.

4. With respect to the moderate change package:

- (a) Do you believe this option would be an improvement over the current tender process?**
- (b) Do you agree with our assessment of this package against the objectives?**
- (c) Do you consider that there are questions that could be removed from the ITT questionnaire (for example, where there is overlap with the EPQ, or where the approach is mandated elsewhere)? For what reason and benefit could they be removed?**
- (d) Are there any amendments to this package that would improve it?**
- (e) What are your views on the most appropriate ways to mitigate the challenges of this package?**
- (f) Are there other considerations we should have taken into account that present practical or other challenges to implementation?**
- (g) Where we were to allow conditionality only on particular elements of a bid, how should we take into account conditionality in bids which cumulatively raises concern about the overall robustness of the bid?**

We understand Ofgem’s position in the consultation that the finer details of tender reform have yet to be decided and Ofgem is instead interested in the broader policies underpinning reform.

We see merits and risks in both the ‘moderate’ and ‘significant’ change packages. Vattenfall’s preferred principles in approaching tender reform are that:

- It is right to take steps to increase the level of competition in the final stages of the tender by removing restrictions on the number of bidders who can progress beyond ITT. However, it is important that the costs to developers and OFTOs of managing the tender process are kept under control;
- There should be a much greater focus on operation and maintenance and bidder approach to innovation in selecting the preferred bidder. There is a significant risk of major negative unintended consequences if bids are assessed on price alone;
- It is critically important that bidders are strongly incentivised to minimise change to bids after ITT stage and a financial penalty such as a bid bond is a good idea and needs to be sufficiently robust to secure desirable policy outcomes.

On the specific ‘moderate’ reform package as outlined by Ofgem, we have strong concerns over TRS being based on price alone. Price and value for money are not the same and, in a competitive environment, bids which focus exclusively on price may encourage a race to the bottom in terms of quality of asset management, despite a minimum threshold on other matters which are legitimate policy aims. Ofgem express similar concerns in the consultation.³

There is even a risk in a concentrated OFTO market, evidenced by our analysis above, that removing quantitative analysis around issues other than price may create a perverse incentive for OFTOs to collectively lower the quality of their bids banking on the fact that Ofgem may pass sub-par bids to avoid derailing an OFTO tender process.

³ Ofgem, *Consultation*, para. 3.19.

Although Ofgem's ITT process should identify a technically robust bidder, we believe as a principal that lowest price and best value for money does not equate to the same thing. We strongly encourage Ofgem to continue with a strong element of asset management as a determining factor in preferred bidder status.

A key part of Ofgem's approach to financial and operational risk management specifically with respect to the existing tender process is the 60/40 split between tender revenue stream and underlying assumptions in assessing bids, and technical competence only represents 25% of the 40% element. Ofgem may wish to consider whether this split is appropriate and whether more, rather than less, weight should be given to the operational and financial assumptions behind bids.

There are various ways to approach this problem, but building on Ofgem's concept of progressing a certain number of bids through ITT on the basis of lowest price, Ofgem could consider a process where the top three lowest tender revenue stream bids are progressed through the ITT stage for consideration against the relative robustness of operation and maintenance track record, financing, and approach to incorporating innovation. These could be assessed on a quantitative basis to provide a relative ranking on which to base the final tender award, rather than a binary 'pass or fail' against these critical criteria as currently proposed.

We do have concerns, however, with the principle of restricting competition to 3-5 bidders and believe this restriction should be relaxed. We are also concerned about Ofgem's rationale for limiting competition as it benefits bidders who 'may not want to participate in a fairly resource intensive ITT process'. If the level of resource required in bidding for multi-million or even billion pound assets is a barrier to potential bidders then we believe they are not the kinds of participants who should be participating in the regime.

We support the views suggested in Ofgem's consultation of removing conditionality from OFTO bids.⁴ We believe conditionality should be largely or entirely removed from the bidding process even without the other reforms proposed. We are concerned that, even prior to reform, conditionality in bids allows OFTO bidders to offer unrealistic prices that they are then able to claw back in an anti-competitive way at a later stage. This perverse incentive may be sharpened under any move towards basing OFTO award purely on price.

Ofgem may wish to compare OFTO tenders with similar processes in other areas of energy policy. For example, generator bids under the Contract for Difference (CfD) mechanism are unconditional and, moreover, generators are subject to strict 'non-delivery disincentives' for rejecting offered CfD contracts or failing to meet project commitments. Similarly, the Capacity Market does not include any retrospective ability to adjust the awarded price conditional on project development. In this regard, OFTOs are already at a relative advantage compared to CfD and CM participants as OFTO bidders are able to perform due diligence on an asset at an advanced stage of development compared to generators who may still encounter unanticipated conditions or delays materially affecting their bids.

We believe the regime could also be reformed through permitting the rolling extension of the current time-limited exemption (known as the Generator Commissioning Clause) from requiring an electricity transmission licence. Such extensions would apply in cases where generators and

⁴ Ofgem, *Consultation*, para. 3.20.

OFTO preferred bidders are negotiating commercial solutions to bid changes. We believe that there is a high level of risk that the hard deadline around transmission licence exemptions could be used by OFTO bidders to force generators into accepting uncommercial settlements.

With regards to simplifying the ITT process through removal of certain questions,⁵ Vattenfall would need to see the proposal before it can comment. However, we support the principle of simplification where this is due to repetition or because questions are no longer necessary. We do not believe it is Ofgem’s intention, as outlined in the consultation’s drafting, to reduce the robustness in appointing a preferred bidder but we would have concerns if we have misunderstood the intention.

5. With respect to the significant change package:

- (a) Do you believe this option would be an improvement over the current tender process?**
- (b) Do you agree with our assessment of this package against the objectives?**
- (c) Are there any amendments to this package that would improve it?**
- (d) What are your views on the most appropriate ways to mitigate the challenges of this package?**
- (e) Are there other considerations we should have taken into account that present practical or other challenges to implementation?**
- (f) What do you think of potential bid bond arrangements, pain/gain share mechanism and consequential changes to allow efficient unconditional bids?**

We have major concerns with the ‘significant reform’ package, for the same reasons outlined in our response to question 3 above. We would not welcome any move towards OFTOs being awarded to preferred bidders solely on price and without significant weight being given to operational or financial robustness of bids.

We support Ofgem’s desire to encourage new entrants to the OFTO market but we do not believe this is best achieved by ‘dumbing down’ the requirements of the bidding process or focusing exclusively on price. Ofgem may wish to consider other ways by which it can increase bidder interest, which might include the extent to which the policy is marketed to external parties, including those based outside British financial institutions and investment houses. Removing the cap and number of bidders progressing beyond ITT could go some way towards improving competition.

Ofgem may also wish to consider whether the concentration in the market, evidenced by Vattenfall’s analysis above, may be perceived as a barrier to new entrants who may see the OFTO market as one which is ‘stitched up’ by incumbents who are familiar with the process of bidding. Although the impact on competition would need to be carefully considered, this could be tackled by restrictions around market concentration or providing some preferential status to new market entrants who are able to demonstrate very strong operational expertise.

⁵ Ofgem, *Consultation*, para. 3.18.

As mentioned in our response to question 3, we support Ofgem’s move to require unconditional bids. We also support the concept of a bid bond, although we are unclear how this would have an impact on tender revenue stream bid price if the bid bond is cancellable at the point of financial close.

Ofgem mentions consequential changes being required as a result of the ‘significant reform’ package. We do not foresee any issues with requiring more detail from developers at ITT providing that the preferred bidder stage is proposed to be shorter.

We agree there is a theoretical risk to the Generator Commissioning Clause in starting the ITT stage later, but we believe this could be solved through the granting by Ofgem of extensions to the Generator Commissioning Clause. In particular, delays may arise through no fault of the generator.

6. Are there other packages of change that we should consider that would better deliver against the objectives?

Vattenfall has argued in this consultation response for an increase in focus on operation and maintenance and incorporating approach to innovation in assessing bids. We are aware that these areas are understandably not necessarily part of Ofgem’s core skillset and so Ofgem may wish to consider introducing an independent, annual technical audit requirement, similar to a financial audit, which assesses whether an OFTO has continued to meet good industry practice during the operational phase.

Ofgem may also wish to consider whether generators should offer a ‘shadow’ tender revenue stream bid and operation and maintenance schedule, which could serve as a yardstick against which OFTO bids are assessed for technical competence and to inform whether cost benefit analysis demonstrates an improvement in value for money arising from the OFTO regime.

7. Question 7: With respect to the other tender process changes considered that could apply to either the current tender process or any of the potential packages for change:

- (a) Does Vendor Due Diligence (VDD) in practice reduce the total cost of a tender process? Are there any benefits in broad VDD? Are there benefits in a more focussed approach to VDD (for example a Certificate of Title)? Under what conditions and to what extent would bidders base their bid on VDD?**
- (b) Are there other cost-effective ways in which the bidder data room could be improved to the benefit of all parties? Are there specific ways to further standardise the structure?**
- (c) What changes, if any, should we consider to our current bond spread methodology? Would an appropriate pain/gain share mechanism for bond-financed bids allow us to fairly assess bond and bank-financed bids on the same committed finance basis?**
- (d) Do you consider that we could adequately rely on a more confirmatory approach to questions? Are there particular documents or questions we could consider not requiring the bidder to produce, but instead confirm? Are there particular documents/requirements that are better left to the PB stage?**

Vattenfall does not have recent experience of the tender process and the current set up of the data-room.

We suspect that the Vendor Due Diligence (VDD) process adds unnecessary expense to developers which is not recouped as value for OFTOs. We do not believe that a competent OFTO bidder would rely solely on VDD and would conduct its own due diligence separately, meaning that VDD is a duplication of effort which adds expense into the overall OFTO process. This is a comparable approach a competent purchaser would most likely take to a comparable asset, such as a wind farm.

We reiterate our point that whilst simplicity in the energy sector is to be embraced, over-simplification of complicated, high-value assets may attract the wrong type of bidder and asset owner.

8. Do you think the approach of Ofgem, developers, and bidders to the tender process will need to change as projects become larger, further from shore and more expensive? What do you see as challenges from this change?

In addition to the drivers for change outlined in the question, asset technology will also evolve. As the value, size, and complexity of offshore transmission assets increases, Ofgem and bidders will need to accept the inherent complexity and risk involved in asset transfer and should not underestimate the complexity involved.

Furthermore, Ofgem will need to familiarise itself with the industry move towards the use of HVDC technology in export infrastructure and how Ofgem interprets the concept of 'efficiency'. The move towards HVDC is likely to result in higher upfront costs, but a more efficient economic outcome in the long-term as losses are lower on HVDC than HVAC.

9. With respect to end of revenue term arrangements, where there continues to be a need for the OFTO, what factors should be taken into account when making decisions on OFTO revenue at the end of the normal 20 year term? When should we begin to make these decisions?

Vattenfall would like to explore with Ofgem whether there is any merit in transferring assets back to generators at the end of the 20 year tender revenue stream period, where those generators have decided there is an economic case for continuing to operate the relevant offshore wind farm. An alternative option may be the default transfer to the TSO on expiry of the 20 year period.

If OFTO assets are to be transferred back into generator hands, then there may need to be a revenue readjustment for the OFTO, which would have been in receipt of 20 years' of revenue on a tender price assuming decommissioning costs for which they would no longer be liable.

10. Is there demonstrable evidence that we should consider changing the default revenue period away from 20 years for future projects? If so, what would be the most appropriate revenue period?

The lifespan of the wind farm on which the export assets depend is likely to be on a case-by-case basis. Ofgem may wish to grant OFTO licenses covering the same period as allowed by the

relevant Development Consent Order, in England and Wales (DCO), or Section 36 consent, in Scotland.