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Dear Akshay,

Vattenfall response to *Open letter: Consultation on Income Adjusting Event policy in Offshore Transmission Licences*

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.

We would like to use the opportunity of this open letter to express serious concerns about the income adjusting event (IAE) policy as well as more general concerns about the OFTO regime.

Vattenfall understands the justification for the OFTO regime at the point it was introduced. This was a time when the value of OFTO assets were comparatively small and the regime for developing offshore wind (the Renewables Obligation) did not feature a competitive element putting downward pressure on prices. However, the market has significantly evolved since then yet change to OFTO policy has been only marginal. The IAE policy developed in Ofgem's *Open Letter* is problematic and a symptom of broader problems undermining the policy justification.

As a result, Vattenfall is calling for an urgent, holistic review of the OFTO regime, with evidence presented by a broad range of industry players, who we expect will be supportive of the principle of such a review. We believe this will demonstrate a strong case for major reform or removal of the policy. I would like to come in to Ofgem to discuss these concerns in more detail with you.

Yours sincerely,



Piers Guy
UK Country Manager, Vattenfall Wind Power Ltd

Annex A – Detailed consultation response

Summary of Vattenfall’s concerns with the general OFTO regime

Vattenfall believes the OFTO regime has not kept pace with market developments and is leading to significant consumer detriment, inefficiencies, and lost opportunities. We believe that an economic value can be established to make this case, but this will be best identified through wide industry consultation.

Some of the areas we have identified which may impact on the overall value of the regime include:

- i. Allowed hurdle rates for OFTO regulated returns (understood to be c.9-11%) are higher than a traditional utility developer would accept in today’s market;¹
- ii. After approximately nine years since the first OFTO was completed, there are still only a very limited number of OFTOs in the market and very few new entrants, which places a question mark against the levels of competition in each tender round and whether or not consumer value is really being derived
- iii. It is our experience that generators’ and OFTOs’ interests are not aligned when it comes to revenue losses caused by a failure, and as a result, OFTOs do not react as quickly to problems developing on assets as generators would, acting in line with our understanding of industry best practice, leading to increased downtime and consumer impacts through the counterfactual of increased carbon emissions and fuel costs through generation substitution;
- iv. Additionally, the OFTO regime does not adequately cater for, or incentivise an OFTO to carry out preemptive repairs to avoid later failures;
- v. Higher failure rates and instances of downtime under OFTO is likely to translate into increased risk perception, which in turn could manifest itself in increased Contract for Difference (CfD) strike prices and therefore consumer impact compared to the counterfactual without an OFTO regime;
- vi. OFTOs are likely to face higher costs for securing insurance and operation and maintenance services compared to developers for whom these activities are well-understood and where economies of scale are achievable;
- vii. The cost associated with running OFTO tenders;
- viii. The costs incurred for generators, OFTOs, and Ofgem in regulatory compliance and enforcement;
- ix. Duplication of cost across generators, OFTOs, and Ofgem with project management and technical due diligence conducted multiple times by different organisations on the same asset;

¹ Cambridge Economic Policy Associates, *Evaluation of OFTO Tender Round 2 and 3 Benefits* (2016).

- x. OFTO policy appears to be attracting participants which are not appropriately financed to manage high-value, complex, and critical infrastructure (in Ofgem’s words ‘thinly capitalised entities’²), and the policy provides a generator with no opportunity to comment on the financial covenant of the OFTO or its suitability;
- xi. The OFTO regime prevents generators from innovating and retrofitting new technology to OFTO assets, such as substations, which would otherwise be in the consumer interest; and
- xii. Decrease in competition in the UK offshore wind market as European developers concentrate investment in regions which lack a high-risk OFTO-type policy (e.g. Denmark, the Netherlands).

Furthermore, we believe the proposed IAE policy also presents major problems. These are explained in more detail below but can be summarised as:

- i. Contrary to Ofgem’s policy intent, OFTOs are now largely completely insulated from the risks of asset ownership,³ which are transferred to parties which no longer have influence over how those assets are operated and maintained. This is contrary to Ofgem’s previous position. In its first IAE decision for London Array OFTO, Ofgem stated that the ‘licensee should enter into such transactions with an awareness that they are assuming any risks arising from damage or defects that they have not been able to discover through their due diligence. The Offshore regime was not designed to insulate licensees from all such risks...’⁴ The framework for the offshore transmission regime also reflects this through the System Operator Transmission Owner Code (STC) which deems the OFTO, for the purpose of STC, to have been the party that developed transmission assets from the point of asset transfer;⁵
- ii. The approach to risk allocation and target rates of return is out of step with comparable Government schemes (e.g. the CfD and Capacity Market regimes do not have similar compensatory mechanisms for developers of the risk of asset underperformance);
- iii. The IAE policy is likely to incentivise OFTOs to rely on time-consuming regulated outcomes to problems, which leads to potential delays in expediting and mobilizing a repair, increased asset downtime, higher financial penalties for

² Ofgem, *Open letter: consultation on Income Adjusting Event policy in Offshore Transmission Licences* (February 2017), p.4.

³ It would appear that the investment community views the existing OFTO regime, even without enactment of proposed IAE policy, as already very low risk. KPMG’s *Offshore Transmission: An Investor Perspective* (2012), available from the Ofgem website, states on p.19 ‘while investments in OFTOs are not risk-free, relatively few risks are borne directly by the OFTO and most of those risks are relatively small and/or can be passed on to third parties’.

⁴ Ofgem, *Determination in relation to a notice of an income adjusting event from Blue Transmission London Array Limited*, p.5 (27 October 2016); similar sentiments are also reflecting in Ofgem, *Determination in relation to notice of an income adjusting event from Thanet OFTO Limited*, pp.13-14 (23 May 2017).

⁵ STC, Section G, para. 6.3.

- generators and other shareholders as part owners of the generation assets, and inefficient outcomes for consumers;
- iv. There is no comprehensive guidance in one place on the IAE process, including Ofgem’s timeframes, principles, and methodologies;
 - v. The perception of significant risk associated with the OFTO regime by developers is likely to place upward pressure on Contract for Difference (CfD) strike price bids; and
 - vi. The risks posed by IAE policy to developers will increasingly become a barrier to investment in UK offshore wind within a European investment context where other regimes adopt a simpler offshore transmission model which still manages to satisfy in EU Third Energy Package unbundling provisions.

We believe the arguments outlined above and in the specific consultation responses below demonstrate that the OFTO regime and IAE policy may add costs to the consumer through inefficiencies, do not secure cost reductions in addition to those secured through CfD bidding, risk unwelcome behavior by OFTOs, and gold-plate the revenues of certain investors contrary to free market principles. The optimum solution for projects beyond Tender Round 5 would therefore be to remove the OFTO regime entirely with a second-best option for existing assets to remove limb C of paragraph 15 of Amended Licence Condition E12-J3.

Ofgem *Open Letter* 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?

Vattenfall is unsure what is meant by the use of the expression to ‘strengthen’ the IAE policy. The effect of the policy proposals appears to be to ‘strengthen’ the position of OFTOs by transferring increasing financial risk to generators, who lack the rights to operate and maintain assets they do not own, including the rights to mitigate the effect of an event which would give rise to an IAE claim. If this is the intention, then Vattenfall disagrees with the policy proposal. In particular, we note that this is a retrospective policy change which requires existing asset owners to take on hitherto unforeseen liabilities.

We note that the apparent policy approach to risk allocation is now fundamentally at odds with the original stated policy intent that ‘the offshore regime was not designed to insulate OFTO licensees from... risks’.⁶ Within this context, we also note a later contradictory statement in the *Open Letter* where it is said that ‘it should be noted that a large proportion of any IAE costs awarded will be passed through to the relevant offshore generator in any event, and so this remains a significant incentive to build fit for purpose assets’.⁷

We believe this highlights conflicting policy objectives which encourage regulatory uncertainty: on the one hand, the intention appears to be to incentivise desirable OFTO by sending messages to OFTOs around the allocation of risk, whilst on the other hand the policy attempts to boost OFTO investor certainty by providing a mechanism which ensures another party pays the bill in the

⁶ Ofgem, *Open letter* (p.4).

⁷ *Ibid*, (p. 6).

event of any problems. By trying to hit these two policy objectives at the same time, we believe the overall impact is to undermine both aspects. We also have concerns over how Ofgem assesses IAE claims. Whilst past IAE determinations have not always granted the full amounts to OFTOs, the determinations is opaque and we are unsure what level of scrutiny and technical oversight is given to claims to ensure they are cost-reflective of good industry practice and efficient. We also note that there is no third party appeals process for determinations, compared to the Capacity Market where Ofgem is the dispute body.

With regards to Ofgem's statement that the IAE policy provides an incentive to build 'fit for purpose assets', Vattenfall believes this incentive is superfluous. Generators are already under significant pressures to build high-quality assets and the loss of revenue from electricity sales and any subsidies alone is sufficient incentive to develop critical export infrastructure. Added to this are reputational pressures for developers with owners, shareholders, and financiers to satisfy. IAE as a route to secure asset quality is therefore unnecessary and leads to negative unintended consequences. It is also wrong to focus on fitness for purpose just in the build phase. The concept also applies through operation and maintenance, at which point the generator has lost all control over the transmission infrastructure it has built and which it relies upon so heavily.

We note that other Government energy policies do not include a comparable policy to make good on asset owner target revenues, for instance with the CfD, Capacity Market, and Renewables Obligation. In all these cases, the asset owner takes the risk of underperformance, including in instances where assets are sold by developers to new owners.

There are even parallels between OFTO and other problematic Government programs where third parties are encouraged by policy mechanics to underbid for infrastructure ownership rights and then look to Government for regulated solutions when things go wrong. It has been widely reported that this has occurred, for instance, with the early termination of the East Coast mainline franchise.⁸

Turning to the specific issue of 'uninsurability' raised by Ofgem in the *Open Letter*, it is Vattenfall's recent experience of the insurance market for export cables that LEG 3 construction insurance is currently available from reputable insurers at a reasonable cost, i.e. less than 2% of capex. We have no specific comments on Ofgem's proposed adoption of HMT's definition of 'uninsurable' events. However, we do believe it is likely that this insurance, on balance, will cover a single event only. We note that HMT's 'uninsurability' guidance assumes that there is an 'Authority', which is not a private sector participant, available to underwrite some of the risk. Ofgem's *Open Letter* does not propose an Authority, and rules out a common fund provided by OFTOs, in favour of directing the liability back to generators. It is therefore questionable whether adopting the HMT position is fair if not translated wholesale.

We therefore believe that Ofgem have correctly identified an issue in the insurance market, however, we disagree with the policy response and we have concerns that it represents a 'sticking plaster' approach which will lead to damaging outcomes, rather than a more holistic review of whether the regime is still securing positive results for consumers.

⁸ See for example, The Guardian, *East Coast rail 'bailout' could cost taxpayers hundreds of millions* (29 November 2017).

In addition, we agree with Ofgem’s identification of the risks of the IAE policy position (i.e. that OFTOs will be disincentivised from seeking insurance, insurers may be further encouraged to withdraw products from the market, and there may be a split in the insurance market between ‘good’ and ‘bad’ insurable risks) and we add to these risks throughout this consultation response. We have concerns that Ofgem’s proposed mitigation to these risks does not go far enough to prevent the risks identified from materialising.

Finally, we do not support the benefits of the policy as identified by Ofgem (i.e. positive impacts on tender bids and protection for ‘thinly capitalised’ businesses). Our concerns with these benefits are outlined elsewhere in this response but, in summary, we believe any benefit on lower OFTO tender bids will be manifest in higher CfD bids from developers due to increased risk perception and we also believe that IAE relief for ‘thinly capitalised’ OFTOs leads to negative financial impacts for developers.

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

It is our view that the existence of an IAE policy may encourage inefficient behavior by OFTOs. Where a problem with an asset arises, OFTOs are encouraged to approach Ofgem for income adjustment rather than expediting a technical solution for the problem. This will inevitably lead to a period of delay during which an OFTO may be more concerned with the question of ‘who will pay to fix the problem’, which could be the insurer, the generator, licence protection, or a combination of these, rather than the question of finding the fault and fixing it. Generator revenues losses, which are frequently uninsured, are likely to amount to millions of pounds. We believe this creates an unhealthy culture of reliance on the regulator rather than markets and leads to continued confusion over where risks lie. This is compounded by a process which relies on subjective judgments about ‘uninsurability’, even with a standardised definition, and the nature of what constitutes an IAE itself, by different OFTOs and by Ofgem. Ensuring consistency amongst the industry will therefore be extremely hard and likely lead to unpredictability in the regime.

At best, this could have a negative impact on generators who are left waiting longer for engineering solutions than would be the case if the developer was asset owner and, at worse, the threat of triggering a lengthy IAE process could be used as a negotiating tactic by OFTOs to force an uncommercial settlement from the generator which would not otherwise happen.

We also dispute the argument that the existence of the IAE regime leads to lower consumer impacts. Whilst it might be the case that the existence of IAE policy feeds into lower OFTO tender bids, we do not believe that this means that the consumer sees the benefit. Due to the risks posed by the existence of the OFTO regime, we believe developers will add an ‘OFTO risk premium’ to their CfD strike price bids meaning the consumer impact is shifted from one place to another.

Ofgem have also argued in the *Open Letter* that IAE policy is required to protect OFTOs which are ‘thinly capitalised’. Vattenfall has a number of concerns with this sentiment. Firstly, we argue that the OFTO regime should not accept owners of critical and complicated infrastructure if they are not financially robust. Other Ofgem policies, for example Independent Distribution Network Operator (IDNO) licenses, go to lengths to prevent the market entry of ‘thinly capitalised’ entities through the requirement of ‘keepwell deeds’ or the holding of financial collateral. Thus there is a discrepancy between transmission and distribution policy.

Secondly, we question the perception that these entities are thinly capitalised. Whilst it might be the case that the SPVs which own the assets are themselves thinly capitalised, the firms which sit behind them are in nearly every case major listed companies (e.g. Mitsubishi, 3i, Balfour Beatty) or private companies with multi-million pound funds (e.g. Amber Infrastructure Group). Therefore, a special mechanism to protect OFTOs to the detriment of similar-sized, or smaller, generator companies is unfair.

Thirdly, if these SPVs are thinly capitalised, it is only because the perception of low risk has allowed these businesses to gear themselves up in that way. IAE policy therefore may exacerbate the problem it seeks to solve.

Fourthly, an IAE policy which protects ‘thinly capitalised’ OFTOs should consider what happens if a new offshore wind developer enters the market which is itself thinly capitalised. Whilst existing industry players have tended towards large utilities which are better placed to absorb financial shocks arising from IAEs, the maturing of the industry may see smaller players entering the market who may fare less well from IAE policy. That aside, some larger utilities are at high risk of credit de-rating, which may be exacerbated or even brought about by any large cashflow impact associated with an IAE claim and lost revenue compounded by an inefficient OFTO regime.

Ofgem has already identified a risk that its IAE policy position may have a negative impact on the provision of insurance. We believe this is a very important risk and there is a real chance the IAE policy proposed puts the provision of OFTO insurance into a ‘death spiral’.

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

Industry would benefit from Ofgem’s view on where IAE costs are expected to be recovered. We note that Ofgem refers to this on page 2 of the *Open Letter* and cites this as a matter for the Connection and Use of System Code (CUSC). Vattenfall believes Ofgem’s view on this matter is required as it will ultimately be called on to decide on the issue in the likely event of a CUSC modification. We note that there is significant confusion in the industry over the interpretation of the CUSC: industry was initially advised by National Grid that IAE costs would be recovered from wider Transmission Network Use of System (TNUoS) charges but this policy position has since been reversed by National Grid in favour of allocating costs to local TNUoS.

It is Vattenfall’s strong belief that IAE costs should be recovered from wider TNUoS and not local TNUoS. As the OFTO regime is supposed to deliver net consumer benefits, and IAE policy is in theory designed to ensure these consumer benefits materialise (although we dispute both these arguments), we do not think it is equitable that consumers bear none of the risks and generators bear all of the risks. This is particularly relevant considering that generators no longer have the ability to mitigate IAE risks and we believe it hence becomes a socialised risk, rather than a local risk for the developer to bear. Furthermore, we note that whilst the financial impact on consumers arising from IAEs is very likely to be marginal, it is a significant for individual generators.

We also have concerns about the impact of the current OFTO regime, and the IAE policy proposed, on future UK offshore wind development. Future offshore wind developers are in effect required to provide very significant contingent liabilities for the lifetimes of these assets,

with no ability to mitigate and manage risks themselves. Given the scale of investment required for new far offshore transmission, the existence of the OFTO regime may well increase the cost of finance, reduce competition, and stifle long-term innovation on export assets. In a worse-case scenario, this may make projects un-financeable, an increasing risk given the long-term policy and market trend towards subsidy-free deployment.

Our view is that consumers will benefit the most through a policy where CfD bids (or eventually the drive to develop subsidy-free projects) will deliver the most efficient projects, where the offshore transmission owner and generator is the same entity incentivised to operate transmission assets most effectively and free to innovate to drive further benefits to the consumer. We do not believe the OFTO policy delivers this and believe the arguments outlined above indicate the need at least for major reform and ideally for removal of the regime.