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Alex Meredith OFTO Transaction Manager Galloper Wind Farm Limited Windmill Hill Business Park, Whitehill Way, Swindon, Wiltshire, SN5 6PB.

Dear Alex,

FAO

Indicative Transfer Value for the Galloper Offshore Windfarm Transmission Assets

Introduction

The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 ('the Tender Regulations') provide the legal framework for the process that Ofgem runs for the grant of offshore electricity transmission licences. Regulation 4 of the Tender Regulations sets out the requirement for the Authority to calculate, based on all relevant information available to it, the economic and efficient costs which ought to be, or ought to have been, incurred in connection with the development and construction of the transmission assets. This process for calculating the economic and efficient costs includes a number of stages, starting with our confirmation of the initial transfer value, progressing to the indicative transfer value ('ITV'), and culminating in our determination of the final transfer value ('FTV') for the project.

We wrote to you on 13 September 2016, confirming that the £329.1m forecast of costs provided to us on 28 June 2016, for the development and construction (including financing) of the Galloper Offshore Wind Farm¹ transmission project ('the Project'), would be taken as its initial transfer value. This value was included in the enhanced prequalification ('EPQ') document and the preliminary information memorandum for the commencement of the EPQ stage for the Project.

Galloper Wind Farm Ltd ('the Developer') submitted a revised cost assessment template ('CAT') for the Project on 17 May 2017 indicating a cost of £323.4m. We have now completed the review and analysis of that CAT and the supporting information the Developer provided to calculate the ITV.

¹ Owned by Innogy Renewables UK Ltd. (25%), Siemens Project Ventures (25%), UK Green Investment Galloper Ltd. (25%), Aldeburgh Offshore Wind Investments Ltd. (25%)

The ITV is an estimate of the economic and efficient costs that ought to be incurred in connection with the development and construction of the transmission assets for the Project. This letter sets out:

- an overview of the work that has been undertaken to inform our calculation of the ITV;
- our conclusion that £291.6m is the ITV for the Project; and
- the next steps in the cost assessment process.

Overview of work to inform the calculation of ITV

We have engaged extensively with the Developer to understand the cost data and supporting information, and used these discussions to inform our view of what constitutes the economic and efficient cost for the development and construction of the Project's transmission assets. We have set the ITV based on:

- a forensic accounting review of the cost submissions;
- additional information provided by the Developer to substantiate costs; and
- our estimate of the allocation and efficiency of costs across relevant cost categories.

The following sections detail the outcome of the forensic review and our considerations of what constitutes efficient costs in each of the cost categories within the CAT.

Findings of the forensic review

We employed independent consultants Grant Thornton ('GT') to undertake a forensic accounting investigation in order to inform our calculation of the ITV. GT checked the accuracy and completeness of the Project's revised CAT; in particular, matching reported CAPEX costs to contract documentation. We have shared and discussed the report on the findings of GT's investigation in detail with the Project team.

Adjustments due to accuracy or updates

GT recommended a number of adjustments should be made to the CAT, due to reporting inaccuracies and updated cost estimates. The result of GT's review is a net decrease to the submission of £2.2m. We have accepted this recommendation and incorporated the adjustments in the ITV.

Unsubstantiated costs

GT was tasked with ensuring traceability of both the contracted costs and estimates of future costs. GT identified \pounds 0.9m of costs where justification of the value of the estimate was insufficient. We have accepted this recommendation and incorporated the adjustments in the ITV.

Findings of Ofgem's review

Our letter on 13 September 2016 set out our views regarding the CAPEX elements of the Project's costs and explained how we would take this forward. We recognise that the costs submitted at the initial transfer value stage were best estimates of the costs at that time. As the Project has progressed, these cost estimates have now become firmer and a significant proportion of the projected costs have been incurred. We have used the 17 May 2017 revised CAT submission that reflects this updated position, after adjustment due to the forensic review as described above, as the basis of our analysis.

Review of individual cost categories

We have undertaken a detailed assessment of the submitted costs on a category-bycategory basis. The following sections discuss each of these in turn, namely:

- Offshore substation platform
- Sea cable supply and installation
- Onshore cable supply and installation
- Onshore substation
- Reactive substation
- Connection costs
- Development costs
- Interest During Construction
- Transaction costs

Offshore substation platform (OSP)

Our review compared the Project's OSP costs with those of other comparable projects. The cost of the Galloper OSP benchmarked higher than comparable projects.

OSP design amendment

We noted that there had been a substantial contract amendment, related to a redesign of the OSP. This redesign was necessary due to inaccurately recorded wave height metocean data being used at the initial platform design stage. We have identified that the following reductions, totalling ± 5.7 m, should be made to reflect the extra costs that were inefficiently incurred as a result of this error:

- £0.9m of project management resources;
- £4.2m in relation to reservation costs for the Oleg Strashnov vessel;
- £0.6m of administrative costs relating to the OSP redesign.

Additional costs to meet ROC commitments

The Developer put in place mitigation measures to ensure the Project maintained its programme and to insulate it from the key risk of delay that would jeopardise its ability to qualify for Project's Renewables Obligation Certificate (ROC). These measures included extra payments to reserve heavy lifting equipment and further costs to allow the connection of turbines directly to the export cables, should there be a delay to the delivery of the OSP. We have disallowed £5.0m because we believe these costs were incurred to protect the generator's revenue stream. We consider these generator costs and, therefore, they will not be included in the ITV.

Contingency

The Developer also reduced the contingency for the OSP by £5.0m, of their own accord, following a review of the remaining project risks.

Other

Despite the reductions referred to in the previous sections (totalling £16.1m), the OSP is still benchmarking higher than other comparable projects. We have identified some factors that may contribute to the higher than expected cost levels. We are currently investigating the following issues:

- 1. The OSP is in deeper water than other comparable projects. We are investigating if there is a correlation between the cost of the OSP and water depth.
- Galloper used EPCI (engineering, procurement, construction and installation) contracts, rather than the multi-contracting approach we have seen on almost all other projects. We assume this approach will include premiums to cover construction risk and warranties. We have undertaken analysis to try to quantify this premium. (Discussed further in 'Cross-cutting issues'.)
- 3. The weight of generator equipment on the OSP may contribute to the overall construction cost. On other projects, we have made reductions if this cost is significant.

Whilst we continue our investigations into the issues described above, we have not made any further reductions to the OSP category. Further reductions may be necessary at FTV but at this stage, we are confident we can explain a significant amount of the difference between the OSP costs and the benchmark.

Submarine cable supply and installation

Our review compared the Project's submarine cable supply and installation costs with those of other comparable projects. The cost of these assets benchmarked higher than average.

Additional costs to meet ROC commitments

The Developer put in place mitigation measures to ensure the Project maintained its programme and to insulate it from the key risk of delay that would jeopardise its ability to qualify for Project's Renewables Obligation Certificate (ROC). These measures included extra payments for cable joints and engineering support should there be a delay to the delivery of the OSP. We consider these to be costs that the generator should bear and so have disallowed £0.2m.

Consequential effects of OSP design amendment

This category also included knock-on costs related to the OSP design amendment. We consider these costs to be a consequence of the error in measuring the wave heights. Therefore, we have disallowed $\pounds 0.6m$.

Contingency

The Developer also reduced the contingency in this category by £3.8m, of their own accord, following a review of their remaining risks.

Other

Following the reductions described above (totalling £5.6m), this category is still benchmarking higher than other comparable projects. Factors that may cause this category to benchmark high include premiums in the EPCI contracts to cover items such as construction risk and the cost of any warranties. This is discussed further in the section 'Cross-cutting issues'.

Whilst we continue our investigations into the issues described above, we have not made any further reductions to the subsea cable category. Further reductions may be necessary at FTV but, at this stage, we are confident we can explain a significant amount of the difference between the subsea cable costs and the benchmark.

Onshore cable

The developer submitted the cost of the onshore cable supply and installation. Our assessment of this cost, against projects of a similar size and nature, indicates the cost incurred is economic and efficient.

Onshore substation

Our review compared the Project's Onshore Substation costs with those of other comparable projects. Following a reduction in contingency and GT's recommended adjustment (totalling ± 0.8 m), the onshore substation cost (including the electrical, design and internal resource re-allocation costs) compares well against the cost for similar projects.

Having considered the costs submitted and the justifications provided, our view is that the costs incurred by the Developer for this category are economic and efficient.

Connection costs

The Developer carried out the works (design, supply and installation of equipment) in the National Grid Electricity Transmission (NGET) substation to connect the windfarm to the National Grid. We consider the full costs included in the ITV submission are acceptable.

Development costs

The Developer submitted costs for this category that include pre-construction development costs and end-to-end project costs, such as project management.

During our assessment, the Developer reduced the contingency in this category by \pounds 7.7m, bringing the total reduction to \pounds 8.5m (including GT recommendations).

Following these reductions, this category compared well with other projects of a similar size, and are therefore considered economic and efficient.

Interest During Construction (IDC)

IDC refers to the cost of financing the development and construction of offshore transmission assets. The Developer submitted costs of £29.2m for this category.

The decisions we have made, with respect to deductions to the project's CAPEX costs for the ITV, result in a consequential IDC reduction. The magnitude of this deduction will be dependent on detailed information relating to the spend profile of included costs, and so is subject to further review. Our current estimate of the IDC value for the ITV is £29.1m.

Transaction costs

The Developer submitted an estimate for Transaction costs of £2.1m, which were included in the Development category. As this level is broadly in line with previous projects, and these costs will only be incurred at the later stages of the Project, we have included them in the ITV and intend to review them at the FTV stage.

Cross-cutting issues

The construction of the Galloper transmission assets was undertaken using two EPCI (Engineering, Procurement, Construction and Installation) contracts. One contract covered submarine cables and the other contract covered the electrical systems (onshore and offshore substations and land cable). When compared to other offshore projects with similar characteristics, the Galloper transmission assets benchmarked circa £28m higher.

The Developer asserted that the EPCI contracts would cause their costs to appear higher because they included a number of advantageous elements such as extended warranties, a single source supplier (which would prove an advantage in a fail and fix scenario) and mitigation of cost escalation during construction.

We considered this information and sought to assess to what extent the Project's excess costs, compared to benchmarking, could be justified by the extra warranties and construction risk mitigation contained in the EPCI contracts. We have employed our consultants, KPMG, to review our analysis, which is ongoing at the time of ITV but will conclude during the FTV stage. For clarity, we have included the higher than benchmark costs in the ITV subject to further assessment into the issues described above.

Ofgem's decision on indicative transfer value for the Project

The ITV for the Project is set out in Table 1, which includes the initial transfer value at EPQ for comparison.

Item	Initial Transfer Value at EPQ (£m)	Assessed Indicative Transfer Value (£m)
Capital expenditure and development costs	298.7	262.5
IDC	30.4	29.1
Total	329.1	291.6

Table 1: Comparison of initial transfer value and ITV

Next steps

The cost assessment process will proceed to the calculation of the FTV and will be based on updates of costs, provided by the Developer. The FTV process will involve:

- A forensic accounting review and closing down the issues identified in this letter; and
- A further review of the Project's expenditure, assisted by independent consultants, as appropriate.

If you have any questions regarding this letter, please contact Katie Taaffe on 0207 901 7014 (katherine.taaffe@ofgem.gov.uk) in the first instance.

Yours sincerely,

Min Zhu, Associate Partner, Electricity Transmission