FAO
Ebba Phillips John
OFTO Transaction Manager
Walney Extension Ltd
c/o Ørsted Wind Power
5 Howick Place
London
SW1P 1WG

Direct Dial: 0141 341 3997
Email: laura.gusberti@ofgem.gov.uk

Date: 12 June 2018

Dear Ebba,

Indicative Transfer Value for the Walney Extension Offshore Windfarm Transmission Assets

We wrote to you on 13 September 2016, confirming that the £516.9m forecast of costs provided to us on 30 June 2016, for the development, construction and financing of the Walney Extension Offshore Wind Farm[1] transmission project ('the Project'), would be taken as its initial transfer value. We included this value in the enhanced pre-qualification ('EPQ') document and the preliminary information memorandum for moving to the EPQ stage of the Project.

Walney Extension Ltd ('the Developer'), submitted a revised cost assessment template ('CAT') for the Project on 10 March 2017 indicating a cost of £533.1m. We have now completed the review and analysis of that CAT, and the supporting information the Developer provided, to calculate the indicative transfer value ('ITV').

The ITV is an estimate of the economic and efficient costs that ought to be incurred to develop and construct the transmission assets for the Project. We have calculated that the Project's ITV is £504.1m.

We are now writing to you to:

- explain how we calculated the ITV;
- point out the next steps in the cost assessment process.

Background

The Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2015 ('the Tender Regulations') govern how Ofgem grants offshore electricity transmission licences. Regulation 4 of the Tender Regulations sets out the requirement for Ofgem to

[1] DONG Energy Walney Extension (UK) Ltd (50%), Pensionskassernes Administration (PKA) (25%), PFA Pension (25%)

calculate the economic and efficient costs of developing and constructing transmission assets. The process for this includes many stages, starting with our confirmation of the initial transfer value, progressing to the ITV and culminating in our determination of the final transfer value (FTV) for the Project.

How we calculated the ITV

We 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;
- 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 as indicated under the paragraph called "Individual cost categories".

The figures in this report are displayed to one decimal place and may be subject to rounding errors.

Findings of the forensic review

We employed independent consultants Grant Thornton (GT) to undertake a forensic accounting investigation 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.

Recommended adjustments

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 £6.1m. 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 initially identified £63.8m of estimated costs where justification of the value of the estimate was insufficient. After further review by GT and Ofgem and significant efforts from the Developer to provide back-up information, this value was reduced to £3.0m. This £3.0m of unsubstantiated costs from the common cost category has been removed from the ITV. These unsubstantiated costs were provided as estimates at the time of submission of the ITV by the Developer and we accepted the justification given at that time to support these costs. The remaining £60.8m of estimated costs should become firm at FTV. We will re-assess these costs to verify they have materialised and can be substantiated with evidence (contracts/variation orders).

Contingency

GT found that the level of contingency, as a proportion of total costs, was reasonable. However, the basis of the contingency calculation is usually the risk register provided by the Developer. In this case, the Developer declined to share the full risk register, therefore GT concluded that it was unable to substantiate the basis of the contingency calculation and the monetary values provided.

We do not approve of the Developer's decision to withhold the full risk register. For future projects, we would expect this to be provided. However, given that, in this instance, the contingency amount, as a proportion of total costs, is in line with that allowed for previous projects, we have included this cost in the ITV. It will be scrutinised further at the FTV stage where we expect the Developer to make risk mitigation activities fully transparent so we can assess the Project's contingency.

Findings of Ofgem's review

Our 13 September 2016 letter sets 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 23 June 2017 revised CAT submission that reflects this updated position, as the basis of our analysis. We have set out our findings in two sections:

1. Non-category specific issues
2. Assessment of individual cost categories

Non category specific issues

Cost reallocations

During our assessment of the Project we undertake benchmarking to sign-post which cost categories require further investigation. To ensure the costs included in each of the Project's cost categories are consistent with previously assessed projects, we re-allocated costs in the CAT as follows:

- Movement of the Digital Temperature Sensing equipment costs from the onshore cable category to the offshore substation (67%) and the onshore substation (33%) categories;
- Movement of Landowner agreements from the common cost category to the onshore cable and onshore substation categories;
- Movement of the directly attributable construction site and commissioning costs from common costs to the offshore substation and submarine cable categories.

Following the reallocation, we benchmarked the Project's costs against previous projects for the different cost categories. The analysis indicated the offshore substation and common costs were higher than expected.

Shared Costs Allocation Methodology

The Developer has used a number of different allocation methodologies to apportion shared costs to the transmission assets, averaging at 30.4%[2]. GT and Ofgem noted that

[2] As indicated on the Grant Thornton "Ex-Ante Cost Review of Walney Extension Offshore Wind Farm Transmission Assets" paragraph 1.15.

this rate is higher than rates we have seen on other projects. We expect the allocation methodology to follow the transmission to generation direct capex ratio, as other projects have done in the past, unless project-specific evidence-based justification is provided.

The Developer's view is that this allocation methodology is not realistic and the allocation methodology it has adopted for this project is more reflective of the true transmission asset costs. Ofgem has considered this, but we have not seen sufficient evidence that the allocations arising from the methodologies proposed by the Developer for the Project are robust and traceable. Therefore, we have reverted to an allocation methodology based on the transmission to generation direct capex ratio.

For establishing the ITV, we agreed with the Developer that the proportion of direct capex associated with the transmission assets compared to the total wind farm direct capex is 26.66%. The impact of applying this proportion is a reduction of £11.1m from the ITV. This arises from two cost items: a reduction of £4.4m from 'shared capex', and a reduction of £6.7m from 'Devex', both in common costs.

Forex

Ofgem expects Developers to protect project costs from foreign exchange movements and we recognise that developers use a variety of financial instruments to achieve this.

The Developer has stated that it did not hedge against foreign exchange movements when it made its Financial Investment Decision in October 2015. Instead, it sought further clarification from us on the treatment of currency exchange movements. In May 2016, we clarified how we would treat the impact of foreign exchange movements during the cost assessment process.

The Developer then placed an initial tranche of hedges for the remainder of the committed project costs and continued to place additional hedges (on a monthly basis) as additional costs were committed or payment timings were revised. The CAT reflects this by putting through all costs at a spot or forecast rate, but then including an offset in the 'other costs' category that adjusts for the hedging gains accumulated during the period from June[3] 2016 onwards.

We expect the exchange rates, relating to committed costs in the CAT, to reflect the hedged rates, rather than the spot rate. We have discussed with the Developer adjusting the CAT, to reflect our view of the appropriate hedged rates that should have been applied. This includes an adjustment for some resource costs, which the Developer elected not to hedge, but which we considered were sufficiently certain to be treated as committed costs for the purpose of hedging. As a result, we agreed an adjustment of £0.4m.

Strategic spares

The Developer included £0.7m of strategic spares in the CAT - £0.5m in the offshore substation category and £0.2m in the onshore substation category. The Developer provided a memo, which stated the total value of the spares would be updated to £0.4m. Therefore, we reduced the ITV by £0.3m.

<u>Individual cost categories</u>

We have assessed the submitted costs on a category-by-category basis. The following sections discuss each of these in turn, namely:

- Offshore substation platform (OSP);

[3] On the basis that this was the earliest period after we clarified our policy stance from which it could hedge

- Submarine cable supply and installation;
- Onshore cable supply and installation;
- Onshore substation;
- Connection Costs;
- Transaction costs;
- Interest During Construction (IDC).

OSP

Our review compared the Project's OSP costs with those of other similar projects, including the electrical, design, contingency and internal resource costs. We applied a net reduction to the OSP cost category of £1.6m. This reduction is made-up of the following components.

We believe the weight of generator equipment is significant enough to justify a contribution from the generator to the overall cost of the OSP. We estimated this cost to be £1.1m. We have therefore reduced the ITV by this amount.

In addition, the Developer updated their submission with the following:

1) a reduction of £0.2m for fabrication service agreements which are no longer required;
2) a reduction of £0.3m of remaining budget for fabrication which is no longer required.

Submarine cable supply

The submitted costs, for this sub-category, include the cost of submarine cable design, supply and a commensurate proportion of internal resource and travel costs assigned to designing, developing and manufacturing the asset. Our view is that the costs are economic and efficient.

Submarine cable installation

The submitted costs, for this sub-category, include the cost of submarine cable installation and a commensurate proportion of internal resource and travel costs assigned to designing, developing and constructing the asset. Our view is that the costs are economic and efficient.

Onshore cable

The submitted costs, for this sub-category, include the costs of the onshore cable supply and installation, and a commensurate proportion of internal resource and travel costs assigned to designing, developing and constructing the asset. Our view is that the costs are economic and efficient.

Onshore substation

Our review compared the Project's onshore substation costs with those of other comparable high voltage projects. Including the electrical, design and internal resource re-allocation costs, the onshore substation cost compares well against the cost for similar projects. In addition, there are costs included for reactive and harmonics filtering equipment.

We have removed £3.0m at the developer's request for costs not incurred and adjusted the value of the National Grid service agreement by £0.2m to cover costs up to first power

only. Having considered all other 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 unlicensed works in the National Grid Electricity Transmission (NGET) substation, following competitive tender for that work. This was because NGET declined to carry out this work for commercial reasons. The Developer has confirmed that these assets are transferring to the OFTO and were procured under competitive tender to NGET's specification.

We acknowledge that these works were necessary to allow the efficient progress of the Project. Accordingly, we consider that the full costs included in the ITV submission are acceptable.

Transaction costs

The Developer submitted an estimate for transaction costs of £3.1m. These cost have been included within the other costs 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.

IDC

IDC refers to the cost of financing the development and construction of offshore transmission assets.

We have adjusted IDC to account for hedging gains (£1.0m). We have also applied a second adjustment as a consequence of the deductions to the project's Capex costs. This results in a consequential IDC reduction of £2.5m. The size of this second deduction will depend on information on the spend profile of included costs, and so it is subject to further review. Our current estimate of the IDC value for the ITV is £44.5m.

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.

The deductions applied to the ITV value submitted by the Developer (£533.1m) are summarised below:

- Forensic review - inaccuracies and cost updates (£6.1m) and unsubstantiated costs (£3.0m);
- Non-category specific adjustments – revised allocation method for shared costs (£11.1m), Forex (£0.4m) and strategic spares (£0.3m);
- OSP – contribution to weight of generator kit (£1.1m), fabrication service agreements and budgeted costs no longer required (£0.5m);
- Onshore substation – costs not incurred at the Developer's request (£3.0) and adjustment to National Grid service agreement (£0.2m);
- IDC – adjustment for hedging gains (£1.0m) and adjustment for capex reduction (£2.5m).

Table 1: Comparison of initial transfer value and ITV

Item	**Initial Transfer Value at EPQ (£m)**	**Submitted ITV(£m)**	**Assessed ITV(£m)**
Capital expenditure and development costs	466.1	485.1	459.6
IDC	50.8	48.0	44.5
Total	516.9	533.1	504.1

Next steps

The cost assessment process for the Project will proceed into the calculation of the FTV, based on further updates on costs to be provided by the Developer as the Project progresses. Following up from this analysis, our investigation at FTV will include (but will not be limited to) the following items: unsubstantiated costs, contingency and transaction costs.

To inform our FTV assessment we intend to work closely with the Developer. The process will involve:

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

If you have any questions regarding this letter, please contact Laura Gusberti on 0141 341 3997 (or laura.gusberti@ofgem.gov.uk).

Yours sincerely,

Cathryn Scott

Director, Wholesale Markets and Commercial