

# Decision

## Decision on developments to the tender process within the current OFTO Transmission Owner (OFTO) regime

**Publication date:** 30 April 2021

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### Overview:

This document sets out the changes we plan to make to the OFTO regime tender process. We have decided on these changes after considering feedback from stakeholders, including that submitted in response to our consultation issued on 18 November 2020.

The changes we have decided to implement will help ensure that efficient, fit for purpose competitions continue to be run within the current OFTO regime. Some changes will be made for the first tender to be progressed under Tender Round Seven (TR7), with further changes anticipated for future tenders.

We are continuing to review the longer-term future of the OFTO regime and will consult further with stakeholders in due course.

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## Foreword

Efficient delivery and operation of transmission assets for offshore wind energy projects forms a core part of the strategy for achieving the UK Government's target of 40GW of offshore wind by 2040.

The present regime for constructing and operating these assets, the Offshore Transmission Owner (OFTO) regime tender process, has operated successfully since June 2009.

In 2020, we decided to review the tender regime to ensure it is optimised to play its part in reaching the 40MW of offshore wind objective in the most cost-effective manner. Our consultation considered the 'generator build' model, where the developer designs and builds the offshore transmission assets before they are transferred to the relevant OFTO, which will operate, maintain and decommission them.

Under the regime, Ofgem runs a competitive tender process to select and license Offshore Transmission Owners (OFTOs). There are 21 operational OFTOs now in place worth circa £5.7 billion in total. We expect that there will be many more offshore transmission assets coming forward for tender in the future.

This document sets out our decision on changes to the OFTO tender process; provides commentary on how we will deal with specific macroeconomic, monetary policy and market changes that affect the OFTO bidding process; and highlights some longer term issues that will shape future OFTO regime policy.

**Rebecca Barnett, Deputy Director, Commercial, Ofgem**

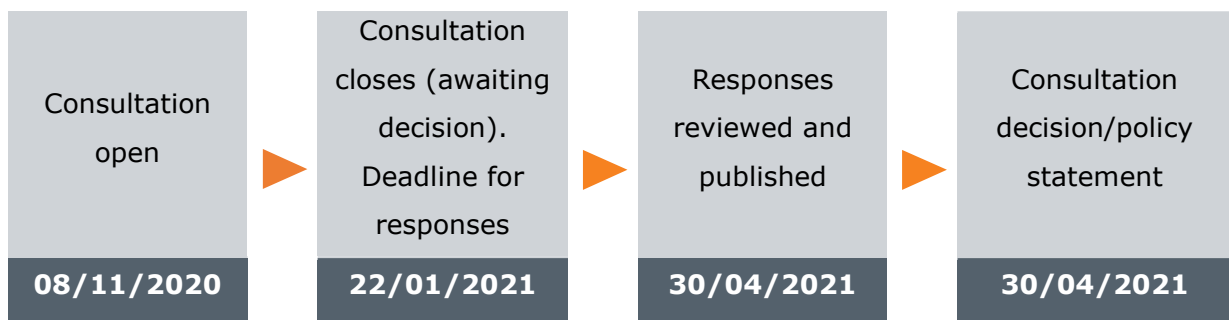
## Context and related publications

- 1.1. The OFTO regime has been in existence for over 10 years, during which time it has become a mature market. To date we have licensed 21 OFTOs across six tender rounds, financed with a highly competitive cost of capital
- 1.2. Our key objectives of the OFTO regime in running competitive tenders for offshore transmission licences are to:
  1. Deliver transmission infrastructure to connect offshore generation, on a timely basis, and ensure that OFTOs are robust and can deliver transmission services successfully over the licence period;
  2. Provide certainty and best value to consumers through the competitive process;
  3. Attract new entrants to the transmission sector; and
  4. Undertake streamlined and efficient tender processes.
- 1.3. Projects are becoming larger and more complex, with developers using newer technology on projects or contemplating how they will use this in the medium to longer term future.
- 1.4. We continually look for ways to improve our tender process and access to the OFTO market for new entrants who could be robust, long-term asset owners at best value to consumers. In advance of starting our next tender round (TR7), we decided to review formally the OFTO tender process, both to ensure that it continues to meet our objectives for the OFTO regime and deliver best value to consumers.

## Our decision-making process

- 1.5. In mid-2020 we engaged with stakeholders to understand any concerns they had about the OFTO tender regime, and to identify any issues that we should consider in relation to the regime.
- 1.6. We published our consultation on the OFTO tender regime process on 18 November 2020. We extended the original closing date from 8 January 2021 to 22 January 2021.

Figure 1: Decision-making stages



## Scope of the consultation

- 1.7. Our consultation looked at a number of items relating to the OFTO tender process with the aim of implementing changes for TR7 and beyond. We were conscious that certain potentially important changes would not be able to be put in place for the first TR7 project which is due to commence in Q2 of 2021. Where improvements can be practically made for TR7 projects, we have done so. For others, we shall engage further with stakeholders where appropriate, with a view to implement changes in due course.

## Your feedback

1.8. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

1.9. Please send any general feedback comments to [jennifer.mcgregor@ofgem.gov.uk](mailto:jennifer.mcgregor@ofgem.gov.uk)

## Data Room

We have decided that allowing earlier access to the data room would not provide significant assistance to bidders. Rather, it is more important that the necessary information is available in the data room at the start of the ITT to allow bidders to undertake full due diligence. In relation to this, we are reminding developers of the guidance set out in the Data Room Guidelines.

To improve the experience of the data room for both developers and bidders, we have introduced a system, Ansarada, which will deliver improvements in document management requested by stakeholders.

### Questions

**Question 2.28: Would allowing earlier access to the developer's Data Room assist bidders**

**Question 2.29: What would indicate that the Data Room is more complete/contains the necessary finalised documentation to enable the ITT stage to commence and what would assist/improve pre-tender submission due diligence?**

## Our decisions

### Background

- 2.1. During our engagement with stakeholders, prior to our formal consultation, we became aware of issues regarding the existing data room structure and functionality. We also heard concerns around the quality of the contents of the data room and the need for developers to fully populate the data room at the start of the ITT process to allow developers to undertake due diligence.
- 2.2. Additionally, for Tender Round 6 (TR6), we introduced the Data Room Contents Overview Questionnaire (DRCOQ), giving bidders an early opportunity to consider the contents of the data room and note which key documents were unavailable, but were required in order properly to conclude their due diligence.

## Stakeholder views

- 2.3. In response to our consultation, stakeholders told us that earlier access to the data room would be beneficial only if the necessary complete and accurate documents were available at the point of opening. We also heard that bidders would like greater visibility of when documents are added to the library
- 2.4. A number of stakeholders raised concerns about delaying the start of the ITT process until the data room was more complete.
- 2.5. Some stakeholders said that opening the data room earlier, when documents may not be available, or information may be more likely to change, could add costs to the process for little benefit.
- 2.6. Stakeholders have generally found the DRCOQ useful, but some noted that we did not allow enough time for a proper review of the data room prior to submission of the DRCOQ.

## Decisions

- 2.7. We have decided to focus on improving the quality of documents available in the data room when it opens, and on how those documents are managed, rather than opening the data room earlier.
- 2.8. Access to the data room will continue to be from the day on which ITT documents for the relevant project are issued.
- 2.9. We will allow additional time for the submission of the DRCOQ. The response deadline for each tender is specified in ITT document for the relevant project. However, we would encourage Bidders to contact us as early as possible should they have any questions about the data room.
- 2.10. We remind developers of the guidance set out in the Data Room Guidelines. Existing Guidelines clearly set out Ofgem's expectations around the documents that should be available in the data room when it opens; following review we have deemed these to be sufficient.



- 2.11. The introduction of a new data management system, Ansarada, for TR7, will deliver improvements in document management, including greater visibility of when documents are added to the library.
  
- 2.12. We will work with developers to agree a pragmatic approach to organising the information in the data room such that it is easily navigable by bidders. Training and support will be provided.

## Site Visits

### Section summary

Site visits are logistically challenging and can be expensive to undertake, particularly for sites further from land.

Stakeholders told us that they do not support site visits being undertaken at the ITT stage, but that visits can be important to assist a Preferred Bidders' (PB) Confirmatory Due Diligence.

We believe that to reduce risks and minimise costs, site visits should be limited to where they add most value. Accordingly, we do not consider there to be value to offshore site visits at ITT stage, but do see the value to such site visits by PBs where they consider it necessary for their confirmatory due diligence. However, we believe that PBs should consider whether technologies such as video links could provide an effective, safer and lower cost alternative.

### Questions

**Question 2.30: Would it be viable or practical for site visits to both offshore and onshore substations to be conducted as part of the tendering process and would this assist due diligence to reduce uncertainties and improve the firmness of bid pricing? In the event that this is not viable or practical, what could be done in advance of bidders submitting their tenders to deal with this issue in a pragmatic way?**

### Background

- 3.1. During the tender process, documentation alone may not adequately demonstrate or describe certain matters of importance to bidders. Accordingly, bidders may wish to visit onshore and/or offshore substations to assist due diligence as part of the tendering process.
- 3.2. We wanted to explore whether site visits at the ITT stage would be viable and practical, and to hear of any potentially effective alternatives to site visits.

### **Stakeholder views**

- 3.3. Whilst one developer said they would be happy to facilitate offshore visits subject to health and safety requirements being met, all other respondents were against offshore visits at the ITT stage.
- 3.4. Consultees were more positive about offshore site visits at the PB stage but emphasised the logistical challenges that such visits present and the need for intensive safety training for all offshore site visitors.
- 3.5. One developer suggested that an Ofgem technical adviser could inspect the offshore asset at ITT stage, providing a report to all bidders.

### **Decisions**

- 3.6. It is clear that there are significant logistical challenges around offshore site visits. Furthermore, as offshore wind farms are increasingly built further from land, these challenges are likely to become even greater. Therefore, we will not require physical visits to be carried out at ITT stage and there will be no requirements placed on bidders or preferred bidders to conduct them.
- 3.7. We encourage consideration of alternatives to site visits which would lessen the operational risks and costs involved in the tender process. Technologies such as virtual reality and live video streams could play a part in this.
- 3.8. We would encourage Preferred Bidders to ensure that any necessary offshore site visits are conducted at the earliest practical possibility.
- 3.9. Due diligence is a matter for bidders and therefore it is not appropriate for Ofgem personnel to undertake site visits; neither could Ofgem appoint a technical adviser to do this.

## Cost Assessment

### Section summary

Cost assessment is a complex process which we are continually refining and one that is vital to ensure that the OFTO regime continues to deliver value for money for consumers. The current process is effective, but we wanted to investigate whether timelines could be revised to reduce the time the process takes. In particular, we wanted to know what stakeholders thought about delaying the ITT bid phase until costs were more certain.

Stakeholders told us they do not support moving the cost assessment process so that the ITT bid phase is delayed until all costs are settled. There was particular concern that this could delay the divestment of the assets and threaten developers' compliance with the Generator Commissioning Clause (GCC) provisions within the Energy Act 2013.

Having listened to stakeholders, we do not plan to delay the ITT process until costs are more certain. However, we believe improvements in certainty can be delivered by increasing speed of provision of the necessary information through the cost assessment process. We will work with developers to investigate how they can play a part in increasing certainty of costs through providing information more quickly.

### Questions

**Question 2.31: Would there be a benefit to moving the timing of the cost assessment process so that the ITT bid phase is delayed until all costs (bar settlement of claims and/or future costs yet incurred) are settled? What are the risks of doing so and how might these be mitigated?**

### Background

- 4.1. Accurately assessing costs of OFTO projects is critically important in ensuring the regime delivers value for money for consumers. Ofgem initially conducts an estimate of the economic and efficient costs that ought to have been incurred constructing the transmission assets (the Initial Transfer Value (**ITV**)) which is provided to bidders at the ITT stage. This cost is used by bidders to prepare their bids. As soon as practicable, Ofgem refines that estimate and provides the Final Transfer Value (FTV) to the appointed Preferred Bidder. Prompt conclusion of the FTV is important to allow asset transfer in a timely manner. A shorter time to

conclusion can reduce costs of the transaction, and therefore minimise costs to consumers. It is therefore in the interests of consumers to ensure the cost assessment process is done as efficiently as possible.

- 4.2. One possible way of reducing the timescales associated with assessing costs is to delay the ITT bid phase until costs are more certain. This could potentially allow for a firmer price to be bid and accelerate process which occurs between appointment of the PB and asset transfer.

### **Stakeholder views**

- 4.3. There was no support from stakeholders for moving the cost assessment process so that the ITT bid phase is delayed until all costs are settled. Developers expressed concern that the proposal would have an impact on their ability to comply with the GCC.
- 4.4. However, there is desire amongst stakeholders to have as many as possible of the issues regarding costs of construction of the assets settled at ITT stage to avoid delays in the PB stage.
- 4.5. Some stakeholders considered that the process could be improved if it were one continuous process, where outstanding issues at the ITV stage were not left unresolved until the commencement of the PB period.

### **Decisions**

- 4.6. We recognise that developers are concerned about the possible implications (of delaying the ITT bid phase until all costs are settled) on their ability to comply with the GCC. Therefore, we will not delay the ITT to settle cost assessment issues.
- 4.7. In order to better settle costs at ITT stage to avoid delays in the PB stage, we will work with developers to increase the efficiency of the cost assessment process. Key to this will be ensuring developers have systems in place and the appropriate personnel available to provide accurate information as quickly as possible throughout the process.

- 4.8. We recognise that there is value in continuing with the cost assessment after the ITV has been set rather than putting it into abeyance for several months. Subject to resourcing and reasonableness, Ofgem will continue to work with developers to settle outstanding cost items in a timely fashion. We would note that this will be subject to ongoing review to ensure that this extended window does not result in protracted negotiations over non-material items which would be to the detriment of Ofgem’s ability to deliver for all projects.

## Transfer and interface agreements

### Section summary

Although bidders can provide comments on both the transfer and interface agreements before submitting their bids, concluding these agreements at PB stage can take many months. If the agreements were closer to being finalised at the ITT stage, two benefits could follow: bidders could price risk more effectively at the ITT stage; and the PB stage could be concluded more quickly.

Stakeholders told us they don't support delaying the submission of ITT bids until the agreements are substantially concluded. However, several respondents believe that the finalisation of the agreements could be made more efficient through a more pragmatic approach to the process.

In line with stakeholder feedback, we do not intend to change the timescales associated with the transfer and interface agreements. We believe that if bidders and developers take a more pragmatic approach to completing the agreements, they can be achieved more comfortably within the existing timescales.

### Questions

**Question 2.32: Would respondents support Ofgem's proposals to delay the submission of ITT bids until the transfer and interface agreements are substantially concluded, with Ofgem delaying the submissions of ITTs until such time as they are considerably more advanced?**

**Question 2.33: If so, what could Ofgem do to ensure that it is effectively managed without needing much extra time in this phase?**

**Question 2.34: If not, what could be done in the alternative in order to provide bidders with the necessary certainty from a pricing perspective, without doing so to the consumer detriment, and also expedite the conclusion of finalising the necessary transaction agreements?**

### Background

- 5.1. In order for bidders to price risk as fully as possible, the intention has always been that at ITT stage OFTO transfer and interface agreements would be in near

final form and represent what both parties consider to be a clearly defined apportionment of risk. Feedback from stakeholders and experience of transactions to date have shown that there are often matters which are still outstanding at PB stage and which result in delays to the overall transaction timetable.

- 5.2. Our consultation considered whether we could change the current process timetable to bring about the desired outcome of resulting in near-final transaction agreements prior to ITT submission so as to bring about a more-straightforward completion of the documents at Preferred Bidder stage.

### **Stakeholder views**

- 5.3. There was very little support for delaying the submission of ITT bids until the transfer and interface agreements are more substantially concluded.
- 5.4. Several respondents – both bidders and developers – suggested that Ofgem should set non-negotiable standards or requirements to be included in the agreements on commercial issues such as liability caps and warranty lengths.
- 5.5. One developer put forward the idea that in order to streamline the process of finalising the agreements, clarificatory questions should be limited in number, and classified by level of importance.

### **Decisions**

- 5.6. We recognise stakeholder concerns around the potential impact on timescales of delaying the submission of bids. Accordingly, we will not make changes to the timetable on this basis. Ofgem does not consider it appropriate to set the levels of liability caps or warranty lengths. The size and length of such protections are market driven and Ofgem does not have the statutory power to mandate such levels. Ofgem does expect developers to offer protections that are on-market, providing Ofgem with sufficient rationale where necessary. Ofgem also expects bidders to be clear where they consider such protection to be off-market and explain why. We will not make any change to the current position that initial drafts will be provided by the developer.
- 5.7. Provided that the developer provides details of all relevant issues relating to the assets in a timely manner to enable bidders to make an appropriate assessment



of risk and to price accordingly, we consider that there is ample time in the ITT process to conduct fulsome due diligence. This view has been reinforced by feedback from consultation respondents. Bidders have considerable opportunity to provide feedback on the data room contents and to ask clarificatory questions in order to complete their due diligence. For this reason, we believe that there is no reason why the transfer and interface agreements cannot be considered 'final' at the ITT stage save for amendments necessary to give effect to the agreements and issues that have arisen subsequent to the submission of the bids.

- 5.8. To achieve this, we remind all parties of the overarching premise of the offshore regime in relation to the generator build model, which was articulated in the November 2018 income adjusting event policy document. The developer bears the risks associated with the construction of the transmission assets and OFTOs are responsible for owning and operating the transmission assets from the point of asset transfer, and for the associated risks arising from ownership of the assets. It follows that developers should not seek to pass on construction risk to OFTOs via the transfer agreements under the guise that it will become an operational risk once transferred, if those risks have manifested themselves or bidders have identified that they are reasonably likely to manifest themselves during the operational period.
- 5.9. This does not mean that developers are to be expected to cover all potential liabilities which may occur, however remote. Bidders should nevertheless enter into transactions with the awareness that they are assuming any risks arising from damage or defects which they have not been able to discover through their due diligence.
- 5.10. We expect bidders and developers to be pragmatic in developing transfer and interface agreements. Developers should be receptive to bidder feedback in iterations of draft agreements at the ITT stage, and bidders should be clear on the issues that are of greatest priority to resolve.
- 5.11. The Preferred Bidder and developer should work cooperatively to complete the agreements within the relevant timescale. Any reopening of terms at the Preferred Bidder stage should be flagged to Ofgem at the earliest opportunity with a clear explanation of the rationale for such request.



## Evaluation Approach

### Section summary

It is important to ensure that the OFTO tender regime delivers optimal value to consumers. In TR6, certain quality and price robustness thresholds were set, with the contract ultimately awarded on price. To ensure the regime achieves the best possible value for consumers, we considered whether there should be a qualitative assessment of bids which assesses each aspect of a bidder's response (financial and operational resilience; financial deliverability; Tender Revenue Stream (TRS)). We would provide a score for each section, which would be weighted and added together to provide an overall bid score.

There was broad support amongst stakeholders for a qualitative approach to assessment, although one respondent believes that Ofgem should effectively continue with the present approach of requiring minimum standards to be met, then make a final decision based only on price.

### Questions

**Question 2.35: Would respondents support in principle a qualitative assessment of all elements of a bidder's bid with each section forming part of the overall evaluation score, and why?**

**Question 2.36: Would doing so lead to bidders proposing engineering solutions that come at high consumer cost for marginal (if any) consumer benefit when compared to robust, yet less costly alternatives?**

**Question 2.37: Could such an approach deliver more environmentally conscientious approaches to operations and maintenance?**

### Background

- 6.1. The OFTO regime has been highly effective in driving competition and continues to provide excellent value for money for customers. However, some stakeholders have previously suggested that the current approach may be undervaluing certain elements of long-term asset management strategies and that there could potentially be more done to drive the right behaviours to ensure long-term asset health to the end of the regulated revenue term and beyond. In our consultation, we asked stakeholders about the value of a qualitative assessment where each aspect of a bid is individually scored and combined to create an overall score

which would determine the Preferred Bidder, and whether this would address concerns about the primacy of a low Tender Revenue Stream at the expense of long-term robustness.

### **Stakeholder views**

- 6.2. Most stakeholders felt that a qualitative assessment of all aspects of a bid could lead to better outcomes for consumers. One developer disagreed, suggesting that instead there should be greater emphasis on stipulating standards in key areas.

### **Decisions**

- 6.3. The tender regime requires certain core standards to be met by bidders, including in relation to operations and maintenance. Since its inception, bidders participating in OFTO tenders were required to pass certain deliverability thresholds.<sup>1</sup> We consider that the thresholds set in order to pass those sections have always set a high bar for bidders. Annual performance of OFTOs suggests that, contrary to perception, OFTOs are on average outperforming the availability target. Since 2014, average availability for OFTO assets has been 99.19% demonstrating that, overall, OFTOs are well managed and there are few incidents or prolongation of incidents that have occurred that are within their reasonable control.
- 6.4. Feedback from respondents suggests that there may be environmental and consumer benefits to be achieved by applying scoring each section of a bid. We will explore this further with stakeholders for potential application in Tender Round 8 (TR8).

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<sup>1</sup> Prior to Tender Round 5, the deliverability sections were scored A to D; however, bidders were required to score at least a B- for the deliverability sections with no value being ascribed to scoring above a B-. Effectively, therefore, the deliverability sections were marked on a threshold basis. The deliverability of the TRS was also evaluated on an A to D basis, with 40% of the overall score being derived from this score. The remaining 60% was based on the bid TRS.

## Funding

### Section summary

Under the current tender model, there is a lengthy period, typically 18 months, between the submission of the ITT bid and financial close. This can cause challenges for debt providers in holding terms for a sufficiently long time. We believe this may be a barrier to entry for debt providers, and in turn for potential new equity investors.

We proposed an alternative two-stage model, where bidders would submit a Tender Revenue Stream using standard debt finance terms common to all bidders. Once a Preferred Bidder is appointed, a debt funding competition would take place to secure the best pricing available from the market and determine the TRS.

Stakeholders, particularly incumbent bidders, suggest there is little benefit to be had from deferring debt finance to the Preferred Bidder stage, and there is some concern that this approach could threaten developers' compliance with the GCC. We received one suggestion for an alternative model.

This is a complex issue, and we do not intend to make changes to the funding process for TR7. Rather we anticipate that any changes would be implemented after TR8. We will continue to engage with stakeholders to consider this and whether there are alternative approaches that would enhance competition.

### Questions:

**Question 2.38: Do respondents consider that deferring debt finance to the PB stage could open up the market to more sources of finance and drive better value for consumers, including Green Finance and, if so, what benefits would that bring to consumers?**

**Question 2.39: Would deferring debt funding competitions until the PB is appointed reduce the costs of bid preparation and be attractive to new equity investors?**

**Question 2.40: Would securing funding later in the process have an impact – positive, negative or none – on the overall time to conduct the tender and transaction process?**

## Background

- 7.1. The historically lengthy period from submission of the ITT bid to financial close can cause difficulties for debt providers in holding terms long enough to support bidders and creates barriers to entry.
- 7.2. We asked for views on an approach where the debt finance competition is deferred until the PB stage. Bidders would submit ITT responses outlining their proposed approaches to and pricing for asset management, insurance and risk management, as well as the capital structure and sources of finance with committed equity returns. Bidders would submit a TRS using standard debt finance terms common to all bidders. Once a PB is appointed, there would be a second stage where a debt funding competition would be run to secure the tightest pricing available from the market and determine the final TRS.

## Stakeholder views

- 7.3. There is little support for deferring debt finance to the Preferred Bidder stage. Whilst some stakeholders told us that the approach could open the market to more funders, respondents felt that benefit was likely to be outweighed by costs associated with reduced certainty and increased risk.
- 7.4. Some alternative models were suggested by respondents, including a bid bond approach (the stakeholder noting that Ofgem had previously mooted this option) and a spread adjustment mechanism that would allow the Preferred Bidder to adjust pricing to reflect prevailing market conditions.
- 7.5. One stakeholder referenced our previous consideration of utilising a bid bond as a mechanism which might serve as an alternative to deferring debt funding until the Preferred Bidder stage and noted that it would merit reconsideration.

## Decisions

- 7.6. Debt funding is the major contributor to bid costs, and assessing the changes that could be made to open the market to more providers will take time. Therefore, we do not propose to make any immediate changes to this aspect of the bidding process.

7.7. We will continue to conduct research and engage with stakeholders on this issue. We consider it likely that any changes to this aspect of the regime would be made after TR8. Regarding bid bonds as a mechanism to facilitate an alternative to deferring debt funding, Ofgem has considered this matter with the assistance of external consultants. We see particular challenges around determining the size, scope and triggers in the context of the OFTO process as it currently exists. Further consideration is required to determine Ofgem’s powers to compel the placement of and implement a call on any bid bond, plus the consequences of what happens to the sums under the bond, before it can be credibly put forward as an alternative approach to the present one adopted. For this reason, bid bonds are not considered a viable proposition at this time and will not be introduced for TR7.

## Reserve Bidder

### Section summary

Stakeholders have previously suggested that Ofgem should be more ready to replace the Preferred Bidder with the Reserve Bidder, to address what is perceived as an asymmetrical bargaining position created by the GCC.

We wanted to hear stakeholder views on whether Ofgem should be more willing to appoint the Reserve Bidder where a Preferred Bidder is not progressing the transaction expeditiously.

Many stakeholders noted that while desirable, it would be costly and resource-intensive to maintain a Reserve Bidder with sufficient readiness that their appointment did not cause delays that may threaten compliance with the GCC.

Given the challenges of maintaining a fully prepared Reserve Bidder, it is preferable that the need for appointing a Reserve Bidder to PB does not arise. This reinforces the importance of developers and Preferred Bidders working constructively and pragmatically together to complete the transaction timeously.

### Questions

**Question 2.41: Should Ofgem exercise its powers to withdraw the appointment of the PB where deadlines are not met?**

**Question 2.42: Should Ofgem set a deadline by which all confirmatory due diligence and/or final approvals from funders must take place?**

**Question 2.43: How could we ensure that it is not the developer that is behind delays leading to deadlines being missed?**

**Question 2.44: What considerations would be needed to maintain the ability of the Reserve Bidder to mobilise quickly?**

### Background

8.1. To date, Ofgem has almost always appointed a Reserve Bidder to stand by and be appointed PB in the event that the PB does not progress with the transaction. In earlier discussions stakeholders brought to light the concern that Preferred Bidders may choose



not to progress transactions expeditiously to attempt to leverage an asymmetrical bargaining position against the developer where the generator commissioning period is close to expiring. We heard views that Ofgem should be more willing to appoint a Reserve Bidder to maintain pressure on the Preferred Bidder to complete the transaction in good time.

### **Stakeholder views**

- 8.2. Some developers told us that having a Reserve Bidder prepared and ready to step in would put helpful pressure on the Preferred Bidder to progress the transaction quickly.
- 8.3. There was concern that the appointment of a Reserve Bidder could be time consuming and threaten compliance with the GCC provisions.
- 8.4. A number of stakeholders expressed concern about the cost of maintaining a Reserve Bidder.
- 8.5. Some respondents suggest that Ofgem should make existing timeline clearer, emphasise consequences of non-compliance, and be more active in enforcing existing deadlines

### **Decisions**

- 8.6. It is in the interests of all concerned that OFTO transactions are completed on time and without undue complication. Developers should not require the threat of the appointment of a Reserve Bidder to drive the smooth completion of the process.
- 8.7. OFTO tenders are complex, and it can be difficult to identify clearly which party is the cause of any delays to the process. This may make it hard to identify which party is causing the delays to the process that may prompt consideration of appointing the Reserve Bidder.
- 8.8. There would be high financial costs associated with maintaining a Reserve Bidder in a sufficient state of readiness to enable them to step in as PB without delay. Furthermore, it would be extremely burdensome on developers to support the necessary due diligence that must be undertaken by a Reserve Bidder to maintain

such readiness. We do not wish consumers to bear additional costs where there is an alternative, less costly, solution.

- 8.9. On consideration of all views submitted, we do not propose to introduce anything additional to maintain the Reserve Bidder's readiness to replace the Preferred Bidder should this be required. We believe that if Preferred Bidders and developers work constructively and pragmatically together, the replacement of the PB with a Reserve Bidder should not be required. Nevertheless, where a Preferred Bidder is not proceeding expediently towards the conclusion of its PB matters, if Ofgem considers it appropriate it will exercise its powers to replace the Preferred Bidder.
- 8.10. We have noted the consultation response suggesting Ofgem should be more active in highlighting and enforcing deadlines through the Preferred Bidder stage. We will seek to have more active engagement with developer and Preferred Bidder during this stage so that every effort can be made to keep to time. This will help Ofgem in its determination of whether it should exercise its powers to replace the Preferred Bidder as noted above.

## Reference interest rates – switch from LIBOR to SONIA

This section focuses on the anticipated move from the London Inter-Bank Offered Rate (LIBOR) to Sterling Overnight Index Average (SONIA).

We asked stakeholders for their views on how it would be appropriate to implement this change for the OFTO tender process.

Almost all respondents told us they believe that SONIA-based products will be used for TR7. Some noted that care must be taken in relation to TR6 projects which have been tendered and awarded on the basis of LIBOR financing, but which may reach financial close after 31 March 2021, when banks are likely to have ceased offering LIBOR financing.

We will introduce SONIA as the benchmark interest rate for TR7 and will work to ensure the transition to SONIA has no detrimental effect on consumers.

### Questions

**Question 3.6: Is your expectation that SONIA-based products will be used for TR7?**

**Question 3.7: What do you consider would be the most appropriate information screens to be used by Ofgem to inform ITT assumptions and benchmarking? Please provide examples/evidence to back up any preferences.**

**Question 3.8: How do you expect bid margins and changes to SONIA to differ to those bid to LIBOR.**

### Background

- 9.1. In previous OFTO tender rounds, the interest rate benchmark underpinning both term loans and IRS was LIBOR. However, Bank of England<sup>2</sup> and Financial Conduct Authority (FCA) have indicated that the London Inter-Bank Offered Rate (LIBOR) is no longer an effective interest rate for many financial products.

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<sup>2</sup> [Transition from LIBOR to risk-free rates | Bank of England](#)

- 9.2. Bank of England and FCA suggest that the Sterling Overnight Index Average (SONIA) will be used from 1 April 2021.

### **Stakeholder views**

- 9.3. Stakeholder responses to our consultation broadly recognise that if LIBOR is phased out as expected by 31 December 2021, OFTO transactions completing after that date will require SONIA based products.
- 9.4. A number of respondents highlighted that financial institutions are expected to cease offering LIBOR-based loans by 31 March 2021.
- 9.5. Almost all respondents believe that SONIA-based products will be used for TR7.
- 9.6. One international financial institution highlights the need to consider the potential impact on TR6 projects that have not yet reached financial close.

### **Decisions**

- 9.7. SONIA will be introduced as the benchmark interest rate for TR7.
- 9.8. We will work to ensure the transition to SONIA has no detrimental effect on consumers, with particular attention to the implications for TR6 projects that will reach financial close after 31 March 2021.

## CPI or RPI Indexation of Revenue

Currently, RPI is the revenue index for the OFTO process. In recent times, regulated markets have seen CPI and CPIH used more widely, including by OFCOM, ORR and Ofwat, and most recently Ofgem using CPIH for RAV indexation in the RIIIO-2 price controls. CPI is also used increasingly frequently in public and private sector transactions.

We asked for views on whether and when it would be appropriate to move over to CPI as a more effective measure. Whilst stakeholders acknowledged the trend towards CPI and CPIH in certain markets, there was concern that the CPI market may be insufficiently liquid to support a transition that index for the TR7.

Taking these comments and our own research into account, we will not introduce CPI/CPIH for TR7.

### Questions

**Question 4.6: For OFTO projects, would a switch to CPI/CPIH or the addition of CPI/CPIH as an alternative option impact on your strategy for revenue indexation and, if so, what would the impacts be?**

**Question 4.7: In your view, would CPI/CPIH-linked indexation result in a net benefit or cost to consumers?**

**Question 4.8: What challenges could you foresee that a change of index or the addition of an alternative indexation option could bring? How would you suggest that any challenges are overcome and/or mitigated?**

### Background

- 10.1. Currently, OFTO bidders can choose to index any proportion of the TRS to RPI and hedge their exposure to inflation risk through a combination of index-linked debt and/or inflation swaps.
- 10.2. At the start of the tendering process for each project, Ofgem provides bidders with a list of reference rates to use in the financial modelling undertaken by each bidder to determine their required TRS. This list currently includes an RPI swap rate as well as index-linked gilt rates for a range of tenors. Bidders are required to apply any relevant spreads and charges on the top of these reference rates.

## Stakeholder views

- 10.3. Respondents noted that CPI / CPIH indexation is being adopted in related areas including RIIO-T2 indexation; one noted that all projects going through the OFTO process are now CfD projects instead of ROC projects, observing that ROCs were linked to RPI, whereas CfD revenues are linked to CPI.
- 10.4. Whilst several respondents recognised that the move to CPI/CPIH was sensible, some emphasised the need for careful modelling to understand the effects the change. A number of respondents expressed concern about lack of liquidity in CPI/CPIH markets in comparison to RPI markets.

## Decisions

- 10.5. In November 2020, HM Treasury announced that the UK Statistics Authority's proposed changes to methodology used to calculate the retail prices index (RPI) will be introduced from 2030; these changes aim to align RPI to the consumer price index including housing costs (CPIH), the current lead measure of inflation in the UK.
- 10.6. Ofgem expects capital markets to price in the expectation of these changes ahead of 2030. However, currently, a wedge exists between RPI and CPIH inflation rates; therefore, switching revenue indexation from RPI to CPIH would require different inflation hedging arrangements. The market for CPI/CPIH-linked debt instruments and derivatives is growing rapidly (as observed, for example, in the water industry), but is not yet as liquid as the RPI-linked market. This is relevant for project finance transactions such as OFTOs due to the typical strategy of fully matching liabilities with contracted revenues. Moreover, it seems appropriate to allow additional time to OFTO bidders and their supply chain to implement any adjustments required in light of the announced changes.
- 10.7. Therefore, Ofgem will retain RPI-linked revenue indexation for Tender Round 7 projects, Triton Knoll and Moray East. At the same time, Ofgem will continue to monitor index-linked markets closely and consider introducing CPIH-linked revenue indexation in future tender rounds.

## Approach to Insurance Requirements

Ofgem currently expects OFTO bidders to obtain LEG3<sup>3</sup> insurance or equivalent. We are aware that LEG3 premiums have risen markedly in recent years, and fewer insurers are offering LEG3.

We wanted to hear stakeholder views on whether there would be any benefit in Ofgem being less prescriptive about insurance requirements, and allowing bidders to decide their acceptable level of risk. We also sought views on whether the ITT requirements should be more prescriptive on other elements of the insurance package.

Stakeholders confirmed that the LEG3 insurance market has hardened, indicated their openness to alternatives, and suggested a range of potential solutions.

We do not propose any immediate changes and will monitor the ability of bidders to secure appropriate insurance cover.

### Questions

**Question 5.7: What are your views on the ITT evaluation continuing to require bidders to take out LEG3 or an equivalent package of cover in ITT bids, or do you consider it would be preferable to allow bidders to decide on the risks that they regard as acceptable?**

**Question 5.8: Should the ITT requirements be more prescriptive about some elements of the insurance cover – and if so, which aspects and what benefits would this bring?**

### Background

11.1. In spring 2018 Ofgem clarified that the income adjusting event (IAE) provisions could apply where a latent defect meant that OFTO assets became effectively uninsurable. At the same time, the Authority introduced a requirement for bidders to include LEG3 cover as part of their ITT insurance proposals, or to provide an

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<sup>3</sup> 'LEG3' or 'LEG 3/06' refers to the London Engineering Group Unique Market Reference for the Model 'Improvement' Defects Wording.

equivalent package of protections, in order to satisfy the relevant award criteria. Our position on uninsurability is settled and it does not envisage altering this in the near future.

- 11.2. We have been informed that the LEG3 insurance premiums have risen substantially, and that fewer insurers offer LEG3 cover for certain elements of offshore transmission assets.
- 11.3. Whilst we still expect OFTO licensees to obtain LEG3 insurance, we wanted to hear what stakeholders thought about that expectation, whether they felt that bidders should be allowed to decide the level of risk they are willing to take on, or if the ITT insurance requirements should be more prescriptive.

### **Stakeholder views**

- 11.4. Stakeholders told us they agree that the LEG3 insurance market has hardened.
- 11.5. Respondents were in general open to alternatives to LEG3 insurance cover, and that bidders should be allowed to decide their own approach to risk, with the proviso that Ofgem should have responsibility for ensuring that whatever risk mitigation package was put in place, it was suitably robust.
- 11.6. An insurance specialist suggested that a mitigation portfolio product may provide a cost-effective alternative to each OFTO securing LEG3 cover.

### **Decisions**

- 11.7. We are aware that there is hardening of the insurance market for the renewable energy industry and this has affected the offshore insurance market. We will continue to monitor the ability of bidders to secure appropriate insurance cover against market changes. Nevertheless, LEG3 insurance remains available and we believe it offers the appropriate level of mitigation. In the absence of currently available alternatives, we will continue to require LEG3 insurance.



## Wider Regime Development

In our consultation, we invited comments on topics relating to the longer-term development of the offshore transmission regime. We received many constructive contributions and will consider them as part of our wider regime development workstream.

- 11.8. In our consultation document we provided an update on our work intended to facilitate more coordinated transmission assets. This work is ongoing. The Offshore Transmission Network Review (OTNR)<sup>4</sup> was launched in July 2020 by the now Secretary of State for the Department of Business, Energy and Industrial Strategy, Kwasi Kwarteng. The objective of the review is to deliver more coordination in the sector and achieve net zero ambitions in a way that strikes an appropriate balance between environmental, social and economic costs.
- 11.9. The importance of greater coordination in the development of offshore transmission infrastructure was set out in Ofgem’s Decarbonisation Action Plan, published in February 2020. Through the OTNR, we are working closely with BEIS and a number of other key stakeholders in identifying issues and developing proposals. The OTNR has four workstreams, and consultations will be launched in all areas later this year. The table below summarises the workstreams and when we or BEIS plan to consult.

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<sup>4</sup> [Offshore transmission network review - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/offshore-transmission-network-review)

<b>Early Opportunities</b> Identify opportunities for coordination of inflight projects	<b>Pathways to 2030</b> Driving coordination of offshore projects connecting before 2030	<b>Enduring Regime</b> Driving coordination of offshore projects connecting after 2030	<b>Multi-purpose Interconnectors</b> Facilitate early MPIs already in development and create enduring regulatory framework
<b>Ofgem consulting Summer 2021</b>	<b>Ofgem consulting Summer 2021</b>	<b>BEIS consulting late Summer 2021</b>	<b>BEIS consulting late Summer 2021</b>
Focused on minor changes to existing regulatory framework	Focused on identifying maximum opportunity for change to existing regulatory framework within primary legislation	Focused on using a more expansive toolbox with potential changes up to and including changes to primary legislation	Workstream interrelates with Early Opportunities workstream in its ambition to facilitate MPI projects that are in early development
Developers have proposed potential coordination 'Pathfinder' opportunities to us	Supports delivery of the 2030 40GW offshore generation target	Aims to deliver coordination through strategic and holistic planning	This workstream also seeks to develop an enduring regime for MPIs, with changes to primary legislation in scope
Ongoing engagement between Ofgem, BEIS, ESO and developers to identify barriers to Pathfinder projects	Focused on delivering infrastructure for offshore projects progressing through current leasing rounds	Three working models under consideration, which sit across a spectrum of coordination	All parties working together to identify issues and consider options for facilitating MPIs
Earlier development MPI projects included in scope and consultation.	Workstream sits between Early Opportunities and Enduring Regime		