Correspondence address:
FAB Link Ltd
17th Floor, 88 Wood Street
London EC2V 7DA

Stuart Borland
Competitive Networks
9 Millbank, London
SW1P 3GE

14 November 2016

Dear Stuart,

Consultation on the Final Project Assessment of the NSL interconnector to Norway

FAB Link Ltd (FAB Link), in partnership with the French national grid company RTE, is leading on the development of the FAB interconnector, a 1400MW electricity interconnector between France and Britain via Alderney (the "FAB" project). FAB Link was granted an Initial Project Assessment (IPA) in July 2015 and is scheduled to submit its Final Project Assessment (FPA) application in mid-2017.

We welcome the additional detail that Ofgem has set out in the consultation document regarding the FPA process and policy positions to be applied. We understand that Ofgem will seek to apply substantially the same FPA process to FAB Link as it is applying to NSL. As such we are making this consultation response in respect of those areas which, if applied to FAB Link, we consider would benefit from greater clarity, a change to the process or policy, or a change to their application.

It is important to note that the FAB Link project is structured for non-recourse project finance and therefore that any ambiguity or lack of clarity in how the RAV (and therefore the floor) will be determined will have an impact on the amount that lenders will be prepared to commit.

We respond on some of the specific questions raised by the consultation in Annex 1 but set out below our main concerns below. It should be noted that there is overlap between these issues (for example the treatment of weather risk could affect both PCR review and contingency amounts fixed at the FPA stage) and as such they should not be considered in isolation.

1. Items to be evaluated at the Post Construction Review (PCR) stage

Greater clarity needs to be provided on the principles used to determine which elements will be evaluated at the PCR stage.

We believe that the criteria for determining which elements will be reviewed at the PCR stage should be both clarified and expanded.

Para 2.18 states that it is necessary to take a view on some items (which are classified as provisional sums) at the FPA stage rather than postpone them until the PCR stage due to "*the scale of these values, and their influence on our current view of total project costs*", essentially saying that as they are potentially large they have to be fixed (in respect of the RAV) at the FPA stage.

The consultation document then sets out in paragraph 3.9 that: "*the PCR will review costs which:*

- *Could not have been reasonably foreseen at the FPA stage; and*
- *Have arisen due to an unrelated third party or external event (ie out of NSL's control)"*

These are slightly different criteria (although not necessarily inconsistent) and it would be beneficial if Ofgem could clarify what the complete set of criteria for review at the PCR stage is. In our view deciding whether an element should be reviewed at the FPA stage or PCR stage is a balance between:
i) ***Efficiency***: Does fixing the allowance for a cost at the FPA stage force an inefficient risk allocation between the developer and the contractor (in which case it would be best left to the PCR stage)?

ii) ***Variability***: Fixing the allowance for a known but difficult to estimate cost (i.e. provisional sums) at the FPA stage forces Ofgem and the developer to seek to agree an estimate of the outturn cost (which will inevitably be wrong), and thereby creates a winner and a loser amongst the developer and the consumer. The bigger the provisional sum, and the greater its potential variability, then the bigger this issue becomes, and in our view this is a reason for dealing with these bigger provisional sums at the PCR stage rather than at the FPA stage (i.e. the opposite approach to that stated in 2.18);

iii) ***Impact on financing***: Fixing the allowance for a cost at the FPA stage allows lenders to have certainty over the floor element linked to this cost element, whereas leaving it until the PCR stage would inevitably require them to adopt a conservative approach in determining the certain level of the floor.

In our view, in order to balance these competing attributes, there may be a case for some provisional sum elements, which are foreseeable but variable, to be reviewed at the PCR stage. In the absence of this it could be in a developer's interest to avoid having significant provisional sums, and therefore to pass risks, more traditionally dealt with by provisional sums, fully onto EPC contractors, who will inevitably price these risks in by incorporating significant contingency margins. This is not necessarily a good outcome for either the developer or the consumer. Again it should not be forgotten that interconnector developers will be strongly incentivised to ensure that provisional sums outturn as low as possible.

Greater clarity needs to be given on the specification of elements that will be evaluated at the PCR stage

Having clarified the principles to be used to determine which elements will be evaluated at the PCR stage, we would expect and require that at the FPA stage it is made very clear how these principles have been applied and therefore which elements will be reserved for PCR review. We do not consider that the consultation document has provided this clarity in respect of the NSL project.

For example, in respect of ***costs and delays due to unforeseen ground conditions***, it is stated in para 3.12 that: "*ground conditions during construction being very different from those expected at the FPA*" would be eligible. It is not clear what "*very*" means in this context. Moreover we would expect that Ofgem (and its advisers) would confirm at the FPA stage whether they had any concerns with respect to the surveys carried out. If there are concerns it is not clear what options would be open to the developer, would it be allowed to continue at its risk but with a suitable contingency pot or is it forced to carry out further surveys? We do not believe that it is a viable option to only find out at the PCR stage that Ofgem has concerns over the surveys carried out, and that this could then be a reason for disallowing costs at that stage. We would expect that, to the extent that it has been agreed that this is a PCR issue, <u>all</u> additional costs allowed under the EPC contract to contractors due to ground conditions should be deemed eligible and efficient (see below re "Burden of Proof").

In general we consider that a list of elements should be specified and agreed and that the eligibility of costs that fall within these elements should be determined by whether additional costs are actually paid under the EPC contracts.

We do agree with Ofgem that the PCR could also include the items which fall within the criteria listed in 3.9 (essentially *force majeure* type events).

2. <u>Burden of proof</u>

Every cap & floor interconnector developer will be strongly incentivised to minimise capex in order to maximise returns when revenues are between the cap and the floor, and to minimise the regulatory risk of costs being disallowed in the RAV by Ofgem. We therefore believe that whilst the developer needs to prove that the cost will be incurred (at the FPA stage) or has been incurred (at the PCR stage), there should not be a need for the developer to show it has been efficiently incurred, unless there is a specific cause for concern identified by Ofgem.

For example in respect of ***costs and delays due to adverse weather***, we disagree with Ofgem's approach described in footnote 15 on page 21 in respect of evidence at the PCR stage. Again the EPC contract will set out the situations in which the contractor will be allowed additional costs and/or time as a result of adverse weather. All the developer should need to demonstrate is that costs have been paid in line with the EPC contract. If Ofgem is seeking the developer to take some weather risk that is not included in the EPC contract (i.e. there could be some weather conditions for which the EPC contractor is eligible for payment or time but the consequences of which would not feed into the RAV), then this should be identified at the FPA stage and a suitable contingency sum allowed for in the RAV at the FPA stage, which is not then reviewed at the PCR stage. However, it should be explicit as to what weather conditions this contingency sum is intended to cover.

Interconnector projects, as recognised by Ofgem's consultants, are very complex and challenging and it is unreasonable to expect an optimal outcome on every issue. In our view, only if Ofgem can demonstrate that the developer has in some way been negligent, should costs reviewed at the PCR stage be deemed to be inefficient.

3. <u>Contingency</u>

It is not clear from the consultation document that Ofgem has made an allowance in at the FPA stage for contingency or risk, other than the £58m placeholder figure which we understand will be fully evaluated at the PCR stage against the criteria Ofgem has set out in paragraph 3.9 (i.e. unforeseeable and outside of NSL's control).

We may have misunderstood this (we hope so)[1] as there is always a need to have a contingency sum to cover unexpected costs and we do not believe that these unexpected costs would always fit into the definition in para 3.9.

We would be grateful for more clarity from Ofgem on how it expects that these normal construction risk contingency items find their way into the RAV.

Again it should not be forgotten that interconnector developers will be strongly incentivised to ensure that contingency spend outturns as low as possible.

[1] We note that almost the whole of section 5 (Project Risks) of the Atkins report has been redacted and the section on the consultation document (paras 2.23 to 2.26) appears to leave all risk related elements to the PCR stage (see para 2.26, page 17).

4. Information Disclosure during consultation

NSL's FPA has been conducted during the execution phase of the EPC contracts. The large level of public disclosure of information relating to the project (a) builds the collective knowledge base for an emerging industry buildout for Great Britain, but also (b) discloses commercially sensitive information that depending on circumstances can be disadvantageous to the developer or even render the developer in default under contracted non-disclosure provisions or procurement regulations. Other projects may require the FPA stage review to be carried out at an earlier stage (certainly prior to financial close in the case of a project financed project). This may require even more redaction of project information than in the case of NSL and this will need to be managed sensitively.

We would welcome a discussion regarding the issues described above and those in Annex 1.

Yours sincerely,

James Dickson
Project Director – FAB Link

Annex 1 – Responses to specific consultation questions

<u>Chapter Two</u>

Question 1: Do you agree with our benchmark of the NSL project?

<u>Methodology of Benchmarking</u>

It appears that the FIDIC (we assume silver book) contract has been used as the benchmark risk allocation for the NSL project.

For a non-recourse project financed project, FIDIC silver book might be used as the basis of the EPC contract(s), however the EPC contracts will ultimately be bespoke contracts with a risk allocation that differs from the FIDIC standard in order to facilitate the financing. We would like to understand what process Ofgem would seek to review the contract conditions. We assume, but would like confirmation, that a risk allocation suited to non-recourse project finance, which in some areas may place more risks on the EPC contractor(s) would not result in any adverse assessment of costs eligible to be included in the RAV.

On a detailed point we do not consider that the inclusion (or not) of a Dispute Resolution Board in the EPC contracts (para 2.6, page 13) is relevant to the cost benchmarking under the FPA process.

<u>Ofgem view of NSL's submitted costs</u>

a) Firm Costs

Ofgem has not agreed, as a matter of principle, to allow the non-contract cost for commissioning power (para 2.13, page 15) (£0.63m). It would be helpful if Ofgem could expand on its reasons for being minded to exclude this cost as it appears to us that this is a cost of bringing the interconnector into service.

b) Provisional Sums

See our comments in the main body of this letter as we consider that in certain circumstances it would be appropriate to review outturn costs associated with provisional sums at the PCR stage. This is particularly the case where the EPC contracting market refuses to offer a fixed price to take a specific risk or only to do so with unpalatable cost increases. It should be noted that review at PCR stage in no way reduces the strong incentive on a developer to keep these costs down, and removes the need to seek to agree a suitable figure at the FPA stage.

c) Variation orders, options and additional provisions

We agree that these items should be assessed at the PCR stage.

d) Risk-related expenditure

Please see the response to Question 3 below.

Question 2: Do you agree with our views on NSL's level of project management?

-

Question 3: Do you agree with our views on and proposed approach to project risks?

In our view there are two distinct categories of cost and delay risks:

i) Those that are reviewed at the PCR stage; and

ii) Those that are not reviewed at the PCR stage.

We have discussed in the main body of the letter our views on the principles for deciding which risks should be reviewed at the PCR stage, and that there is a need both to clarify the criteria for these and to be more explicit on these risks at the FPA stage.

It is not clear to us how Ofgem has assessed those risks that are not to be reviewed at the PCR stage. In particular it is not clear what risk contingency allowance has been allowed for identified items (such as provisional sums) and for unidentified items (general contingency) – it appears there is no allowance for the latter which is not reasonable.

Where Ofgem state that rows coloured green represent costs that we propose to fix at the FPA stage we understand that this means that developers can consider that this sets the lowest possible cap & floor levels, and that these elements will not be subject to PCR (or any other re-evaluation by Ofgem). We should be grateful for Ofgem's confirmation of this.

Chapter Three

Question 4: Do you agree with our proposed approach to the post-construction review?

We agree that costs estimates provided by the developer should be used for operational costs at FPA stage (para 3.1, page 19) and we do not have a view in respect of NSL whether it is appropriate that these are reviewed again at the PCR stage. However, given that this may impact upon financing in the case of FAB Link we would like to reserve our position on whether we consider it appropriate that these costs would be reviewed again at the PCR stage in the case of FAB Link.

It is not clear as to what insurance costs the third bullet in para 3.1, page 19 is referring. We would expect the premia cost of Construction All Risks insurance and third party liability insurance to be determined prior to the FPA stage and therefore could be reviewed at that time[2]. We would agree though that the impact of any claims (for example deductibles which fall on the developer/employer rather than the EPC contractor) should be allowed for at the PCR stage.

Ofgem is proposing to reserve the right to consider adjustments to IDC at the PCR stage in the event that the profile of capex spend profile changes significantly (para 3.2, page 19). This

[2] Unless there are project specific circumstances, such as the significant length of the construction programme associated with NSL which has led to CAR placement in stages or potential exchange rate changes.

could introduce significant risk, complexity and uncertainty to projects (particularly to those using project finance funding structures). In our view it is only reasonable, and should only be necessary, to review IDC associated with capex spend profile in respect of those elements that have been specifically identified at the FPA stage as subject to PCR stage review, or those elements that have arisen due force majeure type events.

Ofgem sets out in the PCR eligibility principles for variance in construction costs that PCR variations will be subject to eligibility and efficiency tests. Please see the main body of our letter in respect of the scope and burden of proof of the PCR stage review.

Question 5: Do you have any other views on the post-construction review for NSL?

Ofgem reserve the right to disallow any within-period revenue assessments until the PCR is completed (para 3.16, page 23). In the case of FAB Link it will be a condition of the financing that if revenue is below the floor as determined by the costs fixed at the FPA stage, then floor payments are made on an annual basis from the first anniversary of the start of operation. If the PCR has yet to complete at this time, it should be possible to have a reconciliation in the year following the PCR completion.

<u>Chapter Four</u>

Question 6: Do you agree with our proposal to set an availability target of 93.0% for the NSL interconnector based on the updated report by GHD consultants?

We note that the availability incentive potential revenue upside (of up to 2%) is if developers outperform against the target level of availability by up to two percentage points (para 4.8, page 25). There does not seem to be any incentive for developers to exceed this two percentage point improvement in scenarios where revenues are above the cap.

Question 7: Do you have any views on the updated regime design, financial parameters or cap and floor financial model?

We understand that there was no variation request made by National Grid for the NSL project and that the default Cap & Floor regime was applied, with no change in the regime design, financial parameters and cap and floor financial model.

We of course have views on the default regime which we have expressed repeatedly over several years through our consultation responses and in meetings with Ofgem – we have not sought to repeat all of our views again here. The default regime needs adjustment to work for projects like FAB Link looking to be financed on a non-recourse basis, and we are willing to continue to work with Ofgem to adapt the regime to agree these adjustments.

{End}