

24th September 2020

Mr Jourdan Edwards
Head of OFTO Regime, Networks
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

Dear Jourdan,

Consultation on proposed modifications to Offshore Transmission Licences

We set out below our response to the Authority's consultation on proposed modifications to offshore transmission licences dated 25 August 2020 (the **Consultation**).

We refer also to the policy on income adjusting events in offshore transmission owner licences dated 28 November 2018 (which we refer to as the **Decision Document** for consistency with the Consultation).

Deductibles for uninsurable claims: all OFTO licences

We agree with the Authority's proposal for establishing the deductible at the same level as that shown in the bid document (for pre 28 Nov 2018 OFTOs) as this will keep the OFTO's risk profile constant

However, we are unsure as to why the Authority intends to (for the post 28 Nov 2018 OFTOs) set a deductible of £5m or 30% of the repair costs (whichever is higher). We believe that it should be for OFTOs to identify the level of deductible required as a result of discussions with the insurance market.

Force majeure: all OFTO licences

Definition of Force Majeure

We have concerns about the implications of the modifications proposed by the Authority in respect of the definition of "Force Majeure" under OFTO licences, and believe that proceeding with the proposals would have negative implications for OFTOs, also for investor and financier confidence in the offshore transmission regime.

We do not support the exclusion of the reference to "fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice)" from the definition of "Force Majeure". These words appear in the definition of "Force Majeure" under the STC that has been applicable to date for the purposes of an assessment under paragraph 15(a) of the Income Adjusting Event (IAE) provisions, and should remain included within any definition of "Force Majeure" that applies to OFTO licences.

The Authority's rationale (paragraph 3.78 of the Decision Document) for exclusion of the wording "fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice)" appears to be based on the Authority's conclusion that its application has a narrow ambit in relation to IAEs.

We disagree with this conclusion for the following reasons. The Authority's view is that the fault or failure of plant and apparatus is most likely a result of a third party's failure (even if not the relevant OFTO's failure) to abide by Good Industry Practice. We disagree with the Authority's suggestion that the requirement to follow "Good Industry Practice" applies to third parties.

For the purposes of this wording in the definition of "Force Majeure" under the offshore transmission licence, the OFTO is the only relevant party that must be required to abide by Good Industry Practice – not third parties. The failure by other parties to follow "Good Industry Practice" is a matter that is wholly outside of the control of the licensee. The Authority's approach is therefore unnecessary as it would hold against an OFTO what a different entity could have done at some previous time.

We are not clear whether the Authority has fully considered the implications for the OFTO regime and ultimately consumers. For example, there is a greater risk in the future that bidders would have to: (i) price contingencies into their bids, which may never be drawn, to the detriment of consumers; and/or (ii) seek latent defect protection from the wind farm developer for the licence period, which is likely to be strongly resisted by developers.

Coverage under paragraph (c)

It appears that the Authority also suggests (paragraph 3.79 of the Decision Document) – in support of its reasoning as to why the wording relating to fault and failure of plant and apparatus is not required – that circumstances of fault or failure can properly be assessed under paragraph 15(c) of the IAE condition.

However, the Authority's proposed application of paragraph 15(c), suggests that there would be circumstances that ought to be covered by the definition of "Force Majeure" that might not be covered by paragraph 15(c). Coverage under paragraph 15(c) is also in the discretion of the Authority and is not an adequate substitute for the wording relating to fault or failure of plant and apparatus under "Force Majeure", which makes it especially important that such wording is retained.

Latent defects

The Authority's approach (paragraphs 3.8 and 3.15 of the Decision Document) suggests that latent defects that can be traced back to the construction of the assets are reasonably foreseeable and, therefore, a licensee should put in place commercial arrangements to absorb such risks. As such, the Authority suggests that an OFTO must demonstrate that it had sought to put in place appropriate commercial arrangements (such as insurance) to manage the foreseeable risk of latent defects.

We do not agree that latent defects that can be traced back to the construction phase. Nor is insurance necessarily available for latent defects. The fact that design and construction risks are theoretically possible does not mean that they should be treated as foreseeable. Where a licensee has undertaken detailed and thorough due diligence prior to acquiring the assets and the due diligence does not indicate that a particular risk (such as a particular latent defect in the construction of the assets) might be foreseeable in the licence period, it is unreasonable to expect a licensee to foresee that particular risk. Where an OFTO has undertaken proper ongoing monitoring of the assets and such monitoring activities have not revealed that particular risk, the risk of the defect would not be reasonably foreseeable, it would be beyond the control of the OFTO, and the IAE regime should protect

the OFTO in the event that the risk materialises (subject to reasonable mitigation by the OFTO for example if it receives insurance proceeds).

Therefore, it is important that the wording “fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice)” is maintained within the definition of “Force Majeure” applicable to the OFTO licence and applied with the proper interpretation of “Good Industry Practice” that we suggest above, in order to protect OFTOs from scenarios such as the examples we describe.

There is a risk that the modifications proposed by the Authority would undermine the application of fundamental protections that should be available in relation to unforeseeable risks within the OFTO regime. We have not priced for construction risk in our return expectations, which are materially lower than we would expect for other assets where construction risk is taken.

Implications for the OFTO market

If the Authority proceeds with the modifications with respect to “Force Majeure” proposed in the Consultation, we believe this would have a significant effect on the offshore transmission asset market. For example, the equity and debt markets may need to re-assess the risk associated with OFTO projects, which could lead to increased bids and unnecessary costs being passed to consumers. Future OFTO projects may find it more difficult to secure investment grade credit ratings and financing is likely to be more expensive than has been seen previously. In addition, bidders will likely try to push the risk of failures to the developer, as such risks cannot be fully mitigated through construction contracts (as defect remedies are limited in time and amount) – this is likely to be resisted by developers and could lead to delays in OFTO projects.

Part B (Other proposed modifications to the IAE condition) and Part C (Other proposed licence modifications)

We provide the following comments regarding the above proposed changes:

We agree with the Authority that the information required by an OFTO to support an IAE claim can be significant. We support the need for Ofgem to include time in the process for a consultation window. However, we believe that it is essential for the Authority to establish a set time period for decision making.

We accept the Authority’s position that any commercial recourse obtained by the OFTO should offset the level of an IAE award. However, the Authority should note that pursuing commercial recovery from third parties can be an expensive and time consuming process. We believe that there needs to be a mechanism where the OFTO and Ofgem can agree an appropriate cost recovery.

We are concerned about under what circumstances the Authority could revoke an IAE award. This proposed amendment will remove the certainty of the Authority’s decision, which creates regulatory uncertainty that the OFTO will be at risk that the Authority may revoke an IAE award.

Please do not hesitate to contact me if you wish to discuss further any aspect of this response.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Nathan Wakefield', written over a light grey rectangular background.

Nathan Wakefield

Director Asset Management

