

To all with an interest in offshore
electricity transmission

*Promoting choice and value for
all gas and electricity customers*

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Dear Colleague,

Providing additional flexibility in the enduring regulatory regime for offshore electricity transmission – Ofgem E-Serve/DECC open letter

This joint Ofgem/DECC open letter outlines our intention to consult further on the enduring regulatory regime for offshore electricity transmission. In addition to the existing 'OFTO build' approach, we propose to consult on providing the option of enabling generator developers to design and construct the transmission infrastructure which would then be transferred to an Offshore Transmission Owner (OFTO) that has been appointed by a competitive tender. This letter also sets out the challenges which we expect will need to be addressed in order to implement such an approach. This letter will be followed by a consultation on the enduring regime, which will discuss these and other relevant issues in full.

The letter also provides details on the commencement of the new regime for transitional projects; new tender regulations; and next steps.

Commencement of the regime

Ofgem and the DECC have worked together over the past five years to develop a regulatory regime for offshore electricity transmission which provides flexibility and supports the delivery of significant volumes of offshore generation while protecting the interests of present and future consumers.

In June 2009 following extensive consultation the previous Secretary of State for Energy and Climate Change commenced powers to enable modifications to be made to the industry codes and licences for the purpose of offshore transmission ("Go-Active"). This also enabled Ofgem to begin the process of identifying OFTOs through competitive arrangements under tender regulations approved by the previous Secretary of State. On 23 July 2009, Ofgem E-Serve commenced the first transitional tender round for 9 offshore wind projects, with transmission assets worth £1.1 billion. There has been strong competition in these tenders and Ofgem E-Serve has received bids from five firms representing a significant investment appetite. This demonstrates the strength of the offshore regime in attracting the investment needed, at a competitive price for generators and ultimately consumers.

The Secretary of State is now commencing the remaining statutory provisions (“Go Live”) for the transitional regime. The regime is applicable to assets built by the generator that have transferred to the successful bidder following the competitive tender, enabling Ofgem to grant a transmission licence to that successful bidder. The Government expects to fully commence the provisions of the Energy Acts on an enduring basis following the conclusion of the consultation on the enduring regime.

Consultation on the enduring regime

In December 2009 Ofgem E-Serve issued a consultation on the enduring regulatory regime for offshore electricity transmission. This focused on a limited number of aspects of the enduring regime, within the framework put in place by DECC at “Go-Active”. The consultation stressed the key principles of providing flexibility and facilitating the delivery of significant volumes of offshore generation. It also set out minded-to positions in respect of key elements of the enduring regime. Among other things, it outlined the range of timings at which Ofgem considered it was appropriate for a generator to request the appointment of an OFTO.

Under the enduring framework put in place by DECC in June 2009, the OFTO would assume responsibility for the procurement, construction, operation and maintenance of transmission assets. However, the December consultation outlined a minded to position that provided flexibility over when the generator could request a tender (as long as it had met the tender entry conditions). The spectrum of options ranged from the OFTO undertaking all preconstruction activity to this being taken forward by the generator.

Ofgem E-Serve received 21 non confidential responses¹ to the December document. The majority were from developers of generation projects. Responses were also received from parties active within the offshore transmission supply chain and from a potential OFTO. Many of these responses raised concerns and proposed changes to the regulatory framework beyond the scope of the consultation.

Generators unanimously raised the concern that the regime would increase risk for generators as they would have less control over the design and delivery of those assets. They also argued that a generator would have more at stake than an OFTO should delivery be delayed. We have previously noted that there is a strong incentive in place, as an OFTO would not receive its full revenue entitlement until delivery was complete. This has shown to be the case in the PFI/PPP sector.

Generators also claimed that, at best, financiers of generation projects would respond to this perceived risk by levying a premium which could increase costs to consumers and, at worst, the offshore generation projects would not be approved at Board level due to uncertainties about the identity and capability of the OFTO. They therefore proposed that generators be given the enduring option of constructing the offshore transmission assets themselves. However, we note that feedback from prospective OFTOs and new entrants to the UK offshore transmission supply chain has been broadly supportive of the enduring regime proposals set out in the consultation document.

A ‘generator build’ option

Ofgem and DECC have engaged extensively with the stakeholder community and carefully considered the arguments raised by respondents. We are seeking to create a regulatory regime which reflects the needs and preferences of generators and offers flexibility, while protecting the interests of present and future consumers and facilitating the delivery of offshore renewable generation. Therefore, we consider that it is pragmatic to consult further on extending the flexibility of the enduring regime to include the option for generators to build offshore transmission assets, before transferring them to an OFTO

¹ All non-confidential responses are available on the Ofgem website.

appointed through a competitive tender process. For ease, we term this a 'generator build' option. This is in line with Ofgem and DECC's continued consideration that licensing OFTOs through competitive tendering has the potential to attract a significant number of new entrants to the sector, bringing innovative solutions to the design, build and financing of the new offshore infrastructure, ultimately bringing best value to consumers, and is compatible with EU law (including the forthcoming implementation of the EU Third Energy Package).

Therefore we intend to consult on putting in place a regime which allows generators to choose whether an OFTO undertakes all, some or none of the work associated with construction of offshore transmission assets. In all cases an OFTO will be responsible for the ongoing ownership, operation and maintenance of those assets. This approach does not exclude generators from choosing the option of appointing an OFTO for the design and construction of transmission assets. We consider that competitively appointed OFTOs have scope to add value in the design and construction of offshore assets. In particular, they have scope to identify the synergies of design and operation, potential of standardised equipment and opportunities for interconnection and asset sharing. In addition, we believe the incentive to bring in new entrants to the offshore transmission asset supply chain is likely to be stronger for an OFTO.

We consider that providing generators with a choice about the construction role of an OFTO may allow the different preferences of present and future offshore generators to be reflected and solutions which minimise risk and cost to be found. We recognise that prospective OFTOs have opposed a 'generator build' option. They consider that the regime would lose several benefits with the inclusion of this option, including design innovation. They have concerns about the feasibility of such an approach, and feel there may be alternative ways of addressing generator concerns. Through consultation we hope to identify views from across industry to determine the suitability of the approach.

We recognise that this would be a significant policy shift. We note that a 'generator build' option would have elements in common with the existing transitional arrangements. It is clear, however, that implementing a 'generator build' option is not simply an extension of the existing transitional arrangements. There are a number of potential issues that would need to be resolved. These are outlined in the next section. The forthcoming consultation will seek to address these issues and identify potential approaches to resolving them.

Developing the 'generator build' option

Key Principles

There are key principles within the current framework that we consider are necessary to promote the development of offshore transmission networks as part of the integrated National Electricity Transmission System (NETS). These include:

- Timely application to the National Electricity Transmission System Operator (NETSO) for connection to and use of the NETS;
- Compliance with minimum security standards set out in the Security and Quality of Supply Standards (SQSS);
- Requirements to share information to enable development of transmission investment plans;
- Compliance with minimum technical, design and operational criteria and performance requirements defined for transmission system infrastructure in the Grid Code and System Operator Transmission Owner Code (STC);

- Requirements to cooperate and assist other transmission licensees in the development of coordinated transmission investment plans; and
- Requirements to share with the NETSO detailed design information to populate agreements and systems used when operating the national electricity transmission system.

The enduring regime consulted upon in December 2009 satisfies the above principles. It is necessary to ensure that an enduring regime that includes a 'generator build' option does the same.

Main Challenges

The transitional arrangements are time limited (as defined in Schedule 2A of the Energy Act² 2008) and were designed to address the specific circumstances faced by projects that were already under construction or were too far advanced to be considered under the enduring arrangements. It is possible that relatively fundamental changes, including amendments to primary legislation and significant changes to industry governance structures, could be required to enable the implementation of the 'generator build' option. We also consider that there is a strong case for revisiting the allocation of risk under the transitional arrangements and good reason for incorporating measures which can enhance the effectiveness of competition. Hence we consider the 'generator build' option to be materially different to the transitional arrangements and note the significant challenges which are likely to be associated with developing the approach. The forthcoming consultation will be important in gaining all parties' views on the scale of these challenges and the best approach to addressing them. A number of potential challenges are set out in summary below.

- *Competition issues* – The enduring regime is designed to promote competition in delivering offshore assets and to stimulate competition in the supply chain for offshore assets and components. We note that allowing a generator to construct assets could reduce the visibility of offshore opportunities and reduce the effectiveness of competition within the supply chain; with potentially detrimental impacts on customers.
- *Transfer of assets to the OFTO* – Under a 'generator build' option assets will need to be transferred to an OFTO in a timely and effective manner. We will need to consider whether any action is required to ensure that this happens and, if so, the best means for achieving that outcome.
- *Creating appropriate contractual interfaces* – The contractual arrangements for offshore generators, NETSO and OFTOs are underpinned by a standard framework made up of licences and industry codes. For transitional projects, the 'generator build' of high voltage assets was addressed through project specific bilateral agreements and standardised arrangements were not explicitly defined within the standard framework. This arrangement was considered acceptable as there was a limited number of qualifying projects and only applicable for a time limited basis. We consider that on an enduring basis, a standardised approach that defines compliance and other information sharing requirements for offshore infrastructure would be required.
- *Ex ante cost guarantee* – Under the transitional arrangements generators were provided with comfort that at least 75% of the Authority's ex-ante estimate of the costs in connection with the development and construction of transmission assets could be recovered. This decision was taken in light of the infancy of the market and the uncertainty over elements of the regulatory regime which, in our view, justified providing comfort to generators and funders (recognising this increased risk for customers). Given there is now a greater understanding of the offshore transmission market and that generators know ahead of incurring costs the arrangements for

² Reference – paragraph 5(2) of Schedule 2A to the Electricity Act 1989

assessing costs, we consider that the strength of the arguments in favour of providing comfort have diminished.

- *Stranded Asset Risk* – There is a risk under a ‘generator build’ option that a tender process may fail to appoint an OFTO. This could leave a generator stranded. There is, therefore, a question about whether a mechanism is required to ensure that generators are not stranded through the failure to appoint an OFTO in time and, if so, what the mechanism should be.
- *EU Third Energy Package* – The EU Third Energy Package will be implemented in March 2011. Part of the electricity directive specifies the roles and responsibilities of transmission owners in terms of network operation, maintenance and development. We note that consideration may have to be given as to how these roles and responsibilities will interface with a situation under which a generator is responsible for the construction of transmission assets, which are then transferred to an OFTO.
- *Clarity over cost allocation* – Given a generator will be undertaking both generation and transmission work, it is likely that detailed consideration will need to be given to cost allocation issues. It is likely to be important that generation and transmission costs are accounted for consistently across projects and that there are clear rules for identifying which costs fall into each category. A failure to do so might be expected to lead to generation costs being inefficiently or inappropriately labelled as transmission costs and vice versa. We will therefore give consideration to these issues in the context of regulatory reporting requirements and how we would undertake cost assessments in relation to a ‘generator build’ model.

Implementation of the ‘generator build’ option

As noted, changes would be needed to the offshore transmission regulatory regime to introduce a ‘generator build’ option into the enduring regime. There are currently two options available for making changes to transmission licences and industry codes which are:

- The Secretary of State can make changes using powers under sections 90 and 91 of the Energy Act 2004 to amend relevant codes, agreements and licences. These powers were commenced to make the necessary amendments to the codes and licences to implement the offshore transmission regime. The powers under the Energy Act 2004 expire in December 2010 (18 months after “Go Active”).
- Normal governance arrangements where the Authority makes decisions on change proposals brought forward by industry stakeholders.

We note that there are other routes for delivering change. We are assessing the viability of these options for the implementation of the changes needed to introduce a ‘generator build’ option on an enduring basis.

Implementation of a ‘generator build’ option would also require the tender regulations to be further modified. For the avoidance of doubt, issues relating to the EU Third Energy Package will be dealt with through different consultation processes and mechanisms will be put in place separately. We are exploring options in relation to resolving the other challenges set out in this letter.

Ensuring Coordination and Strategic Development of the Offshore Network

Some respondents to the December document and interested stakeholders raised concerns about whether Ofgem and DECC's proposals for the enduring regime would lead to the development of co-ordinated and optimised offshore networks in the timescales required to facilitate the connection of large volumes of offshore generation. Those parties, including existing network companies, argued that a more 'strategic' approach was required.

We recognise the importance of developing a coordinated offshore and onshore network and the benefits it can bring. This was a major driver in the decision to create the NETSO by extending National Grid's onshore System Operator responsibilities offshore and placing a licence obligation on NETSO to develop an Offshore Development Information Statement (ODIS) which gives its best view on the development of the offshore and onshore networks to 2025. The first interim ODIS statement has already been published and we expect the next statement to be published in September 2010 and annually thereafter. We believe this will provide valuable information for offshore wind developers and others with an interest in offshore networks.

The Government and Ofgem are determined to ensure any enduring offshore regime delivers best value for consumers in the short and long term. Within this context, we will therefore be asking the question in the forthcoming consultation how the transmission system can be developed strategically to ensure value for money for consumers through effective coordination between offshore assets and interconnection, and also the onshore and offshore networks.

Other issues raised in response to Ofgem E-Serve's enduring regime consultation

Another concern raised by generators was that a number of projects that are currently taking steps towards construction would narrowly fail to qualify for the second transitional tender round. The Authority therefore made the Tender Regulations 2010, which have been approved by the Secretary of State. These regulations enable those projects that are currently taking steps towards construction the opportunity to qualify for the second transitional tender round, subject to them demonstrating (amongst other things) that they would use their reasonable endeavours to meet the requirements for the developer to have secured financing for the transmission assets within a reasonable time period.

Six projects have already signalled interest in participating in the second transitional tender round. These projects represent up to an additional 2.8 GW of offshore generation capacity and will be worth an estimated £1.8 billion. Ofgem E-Serve expects to take the decisions on qualifying projects for the second transitional tender round later this year.

Respondents also raised a number of other issues around the enduring regime, including the allocation of risk under the current availability incentive arrangements. Ofgem E-serve and DECC have been considering these issues. We have also been developing the other refinements to the regulatory regime set out in the December consultation. These issues will be covered in detail in the consultation.

Next steps

Ofgem and DECC will continue to work with industry to develop and implement the enduring regulatory framework. The forthcoming six-week consultation will outline our proposals under OFTO and generator build approaches, which we expect to publish in early August. It will also consider how these proposals promote strategic development of transmission infrastructure that ensures value for money for consumers. Finally, it will consider options for making the amendments to legal and regulatory frameworks which may be required to deliver these proposals. We will be shortly writing to code owners to undertake a review of the industry codes to identify those changes that might be required to implement the 'generator build' option.

We would encourage interested parties to actively participate in the consultation process and to bring forward options and proposals for amending or refining our policy positions.

As outlined earlier in this letter, Government is commencing Go-Live for transitional projects. Following this, Ofgem E-Serve intends to commence the second transitional tender round later this year. Following the approval of the amended tender regulations,

those developers that consider that they satisfy the relevant qualifying criteria should contact Ofgem E-Serve as soon as practicable.

We recognise that the ongoing consultation on the enduring regime will create further uncertainty to developers and investors. It is our aim, to reach a conclusion on these issues in a timely manner. We note that the long term legal and regulatory framework which has been developed would remain available to developers as an 'OFTO build' option should they want to seek a competitively appointed OFTO to design and construct their transmission infrastructure. Under this framework, generators will be allowed to recover any efficiently incurred pre-construction costs in the development of offshore transmission assets from the appointed OFTO.

Should you wish to discuss the issues raised in this document ahead of consultation, please contact Sam Cope (Ofgem) on 020 7901 7239 or at Sam.Cope@ofgem.gov.uk or Paul Hawker (DECC) on 0300 068 5824 or at Paul.Hawker@decc.gsi.gov.uk.

Yours faithfully,



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