



Making a positive difference
for energy consumers

Simon Rooke
Gwynt y Môr OFTO plc
350 Euston Road
Regent's Place
London
NW1 3AX

Direct Dial: 0203 263 9937

Email: Akshay.kaul@ofgem.gov.uk

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Dear Mr. Rooke

Determination in relation to notice of an income adjusting event from Gwynt y Môr OFTO plc

1. On 30 June 2016¹, the Authority received a notice (the "**Notice**") from Gwynt y Môr OFTO plc (the "**Licensee**") in respect of two events which the Licensee considers to be income adjusting events ("**IAEs**"). The Authority has determined that the first event set out in the Notice does not constitute an IAE for the reasons given in this letter. The Authority will determine the second event set out in the Notice in due course following consideration of further information requested from the Licensee. In this letter, we also explain the details of the first event set out in the Notice, provide a summary of the IAE provision and describe the process we have followed to reach the Authority's determination.

Background

2. The Licensee is the holder of an offshore electricity transmission licence, granted on 11 February 2015 under section 6(1)(b) of the Electricity Act 1989 (the "**Licence**"). The Licensee provided the Notice to the Authority pursuant to paragraph 14 of Amended Standard Condition E12-J3 (Restriction of Transmission Revenue: Allowed Pass-through Items) of its Licence (the "**Condition**"), in respect of an increase in costs and/or expenses incurred by the Licensee which it considers were caused by an IAE.

¹ The complete notice was received on this date.

3. Pursuant to paragraph 16 of the Condition, the Notice gave particulars of:
 - a) the event to which the Notice relates and why the Licensee considers the event to be an IAE;
 - b) the amount of any change in costs and/or expenses that can be demonstrated by the Licensee to have been caused by the event and how the amount of these costs and/or expenses has been calculated;
 - c) the amount of any allowed revenue adjustment proposed as a consequence of that event and how this allowed revenue adjustment has been calculated; and
 - d) any other analysis or information which the Licensee considers sufficient to enable the Authority and the relevant parties to assess fully the event to which the Notice relates.
4. In summary, the first event in the Notice relates to a cable failure on the subsea cable of export circuit 1 on 2 March 2015 (the "**Event**"). The Licensee believes that a copper conducting cable and the fibre optic cable running alongside it had been damaged prior to the transfer of the transmission assets to the Licensee. The Licensee provided an independent technical report² (the "**Technical Report**"), which found that mechanical damage to the conducting cable and the fibre optic cable had occurred during storage or the coiling process that took place before the cable armour was wrapped around the inner strands.
5. As a result of the Event, extensive repair work was necessary to the transmission assets. The Notice relates to the costs and expenses of the repair works and related costs required by the Licensee in the financial year 1 April 2015 to 31 March 2016 (the "**Relevant Financial Year**") in relation to the Event.
6. The Licensee considers that the Event is an IAE pursuant to sub-paragraph 15(a), alternatively sub-paragraph 15(c), of the Condition. The Licensee considers that the Event constitutes force majeure under the System Operator Transmission Owner Code ("**STC**"), pursuant to sub-paragraph 15(a) of the Condition. The Licensee also considers that the Event and the consequential costs were not reasonably foreseeable at tender due diligence or at financial close when the revenue calculations were fixed.
7. The Notice sets out that there has been an overall change to the costs and expenses of the Licensee for the Relevant Financial Year of £10.2 million as a result of the Event.

² [REDACTED]

8. Pursuant to paragraph 17 of the Condition, on 28 September 2016 the Authority requested that the supporting evidence provided by the Licensee in the Notice be supplemented with additional information to enable the Authority to assess whether an IAE had occurred in respect of the Event and the amount of any change in costs and/or expenses caused by the Event. The Licensee responded with further information on 27 October 2016. The Authority further consulted the Licensee on its proposed determination of the Event on 22 December 2016 and the Licensee made representations on 17 January 2017. Following consideration of the Licensee's representations, the Authority requested further information on 24 January 2017. The Licensee provided that information on 24 February 2017. Subsequently, at the Licensee's request, Ofgem met with the Licensee on 18 April 2017 and on 9 May 2017 to allow the Licensee to discuss its representations and further information it submitted in support of the Notice and also notice submitted by Thanet OFTO Limited in support of their IAE claim.

Publication of the Notice and consultation

9. Paragraph 19 of the Condition requires the Authority to publish the Notice, excluding any confidential information, following its receipt. Paragraph 21 requires that the Authority consults with the Licensee and such other persons as it considers desirable before making its determination.

█ The Licensee considered that the details of the Event and certain commercial arrangements should be kept confidential █
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11. Under paragraph 20 of the Condition, we have the discretion to determine the confidentiality of information in the Notice by balancing the need for disclosure to enable relevant parties fully to assess the Event against the risk of seriously prejudicially affecting the interests of a person to which it relates. In the specific circumstances of the Event, the Authority agreed that the publication of certain information about the Event and commercial arrangements might seriously prejudice the interests of the Licensee in respect of its commercial discussions and therefore redacted that information. The Authority published the redacted Notice on 9 September 2016.³

12. In accordance with paragraph 21 of the Condition, the Authority has consulted with the Licensee in relation to its determination and has considered its representations in reaching the decision set out in this letter (see paragraph 8 above).

³ A copy of the Notice: <https://www.ofgem.gov.uk/publications-and-updates/publication-notice-income-adjusting-event-gwynt-y-m-r-ofto-limited-0>

13. The Authority has also consulted with the developer of the wind farm, Gwynt y Môr Offshore Wind Farm Limited (owned by Innogy), as it was responsible for the construction of the transmission assets and we considered it may have information relevant to our decision. We have also discussed certain aspects of limb (a) of the Condition with National Grid Electricity Transmission plc ("NGET"), the national electricity transmission system operator and counterparty to the STC, in order to understand its interpretation of the STC.

14. Based on the facts and circumstances of this Event, the Authority did not consider it desirable to consult with any other party before making its determination. This was on the basis that the fact-specific nature of the claim limited the likelihood that any other party would have any additional information in this case that might be relevant to our decision on whether an IAE had occurred and, if so, the proposed level of adjustment.

Income Adjusting Event

15. Paragraph 15 of the Condition defines what constitutes an IAE, as follows:

An income adjusting event in relevant year t may arise from any of the following:

- a) an event or circumstance constituting force majeure under the STC;*
- b) an event or circumstance resulting from an amendment to the STC not allowed for when allowed transmission owner revenues of the Licensee were determined for the relevant year t; and*
- c) an event or circumstance other than listed above which, in the opinion of the Authority, is an income adjusting event and is approved by it as such in accordance with paragraph 21 of this licence condition,*

where the event or circumstance has, for relevant year t, increased or decreased costs and/or expenses by more than £1,000,000 (the "STC threshold amount").

16. As noted in paragraph 6, the Licensee claims that the Event is an IAE pursuant to sub-paragraph 15(a) ("**Limb (a)**") of the Condition, alternatively sub-paragraph 15(c) of the Condition ("**Limb (c)**").

17. Under Limb (a), the Authority must consider whether there has been a force majeure event as construed under the terms of the STC.

18. Under Limb (c), the Authority may approve any other event or circumstance not covered by sub-paragraphs 15(a) and (b) which, in the opinion of the Authority, is an IAE. The Condition does not expressly set out any particular qualifying criteria for determining whether an event constitutes an IAE under this limb. In our decision on an IAE claim from Blue Transmission London Array Limited dated 27 October 2016⁴ (the "**BTLAL**

⁴ https://www.ofgem.gov.uk/system/files/docs/2016/10/btlal_iae_determination_final.pdf.

Decision”), we set out our approach for assessing claims under Limb (c). We have considered the Event in light of the principles set out in that decision.

Limb (a) of the Condition

19. In assessing whether an event or circumstance is an IAE under Limb (a), we must consider whether there has been an event or circumstance constituting force majeure under the STC.

20. ‘Force majeure’ under the STC is defined in Section J, paragraph 3, as follows:

in relation to any Party, any event or circumstance which is beyond the reasonable control of such Party and which results in or causes the failure of that Party to perform any of its obligations under the Code including act of God, strike, lockout or other industrial disturbance, act of the public enemy, war declared or undeclared, threat of war, terrorist act, blockade, revolution, riot, insurrection, civil commotion, public demonstration, sabotage, act of vandalism, lightning, fire, storm, flood, earthquake, accumulation of snow or ice, lack of water arising from weather or environmental problems, explosion, fault or failure of Plant and Apparatus (which could not have been prevented by Good Industry Practice), governmental restraint, Act of Parliament, other legislation, bye law and Directive (not being any order, regulation or direction under sections 32, 33, 34 and 35 of the Act) provided that lack of funds or performance or non-performance by an Other Code Party shall not be interpreted as a cause beyond the reasonable control of that Party and provided, for the avoidance of doubt, that weather conditions that are reasonably to be expected at the location of the event or circumstance are also excluded as not being beyond the reasonable control of that Party;

21. In order for there to be force majeure under the STC, there must be an event or circumstance which both (a) results in or causes the failure of that party to perform any of its obligations under the STC and (b) is beyond the reasonable control of the party, as defined in accordance with the non-exhaustive list of examples provided. The STC definition explicitly includes “fault or failure of plant and apparatus (which could not have been prevented by Good Industry Practice)” as an example of an event beyond the party’s reasonable control. In considering whether the fault or failure could have been prevented by Good Industry Practice, the definition does not restrict this to just “that Party’s” i.e. the Licensee’s, Good Industry Practice.

Determination on whether the Event constitutes an IAE under Limb (a)

22. The Authority has decided that the Event does not constitute an event or circumstance that is an IAE pursuant to Limb (a) of the Condition. The reasons for this decision are as follows.

No failure of the Licensee to perform obligations under the STC

23. First, there has not been an event or circumstance which resulted in or caused the failure of the Licensee to perform any of its obligations under the STC.

24. The Licensee initially considered that the Event resulted in the failure of the Licensee to perform its obligations under paragraph 2.1.1 of Part One of Section C of the STC.⁵ This paragraph provides:

In accordance with the provisions of this Code, each Transmission Owner shall provide services to NGET consisting of ... making available those parts of its Transmission System which are intended for the purposes of conveying, or affecting the flow of, electricity, so that such parts are capable of doing so and are fit for those purposes.

Together with the services defined in paragraphs 2.1.2 and 2.1.3, these services are defined as "Transmission Services".

25. We note that paragraph 4.1 of Part One of Section C of the STC defines the obligation on the Transmission Owner to provide Transmission Services:

Transmission Owner shall provide Transmission Services to NGET, pursuant to paragraph 2, in accordance with its Services Capability Specification (including to any Normal Capability Limits) except, and only to the extent that:

4.1.1 the provision of such Transmission Services is reduced due to an Outage in accordance with Section C, Part Two;

4.1.2 its Transmission Services are not, other than by reason of an Outage, physically capable of being provided or are not capable, for immediate safety reasons or pursuant to environmental obligations, of being provided in accordance with the Services Capability Specification (referred to as a "Services Reduction"); or

4.1.3 the Transmission Owner has notified NGET of technical limits applying in excess of Normal Capability Limits pursuant to paragraph 4.14."

⁵ You can find a copy of the STC on NGET's website www.nationalgrid.com/uk

26. Paragraph 4.1 therefore does not oblige the Transmission Owner to provide Transmission Services where there is a Services Reduction or the provision of such Transmission Services is reduced due to an Outage (each as respectively defined by the STC).
27. The Event constituted a Services Reduction. As the obligation under paragraph 2.1.1 read with paragraph 4.1.2 does not require Transmission Services to be provided where there is a Services Reduction, we do not consider that there has been a failure to perform the obligation under paragraph 2.1.1 read with paragraph 4.1.
28. We confirmed this to the Licensee and queried whether the Licensee had identified any other obligations that it failed to perform. In its response, the Licensee confirmed that it had not identified any other obligations the Licensee had failed to perform under the STC as a result of the Event.
29. However, the Licensee noted that it considers that the question of whether the Event resulted in the Licensee failing to perform an obligation under the STC is not significant in the case of an IAE. The Licensee considers that the reference in the force majeure definition to a failure to perform an obligation is present solely because the function of the force majeure definition within the STC is to give relief from a failure to perform an obligation under the STC. Whereas, when this definition of force majeure is cross-referenced in the context of an IAE, it is not being used for such purposes and so the Licensee considers that element of the definition is therefore irrelevant and so can be ignored. The Licensee considers that this is consistent with Ofgem's interpretation of a similar reference to force majeure under the BSC and CUSC in relation to NGET's request for an IAE under its licence in relation to the Moyle Interconnector outage (the "**Moyle Interconnector Decision**")⁶.
30. We do not agree with the Licensee's reasoning. Limb (a) of the Condition requires Ofgem to consider whether there has been a force majeure event as construed under the terms of the STC. It therefore refers to the definition of a force majeure event under the STC, without amendment or qualification. We have not identified any evidence that it was intended in the establishment of the OFTO regime that this pre-requisite would not be relevant in the IAE context, such that deviation from applying standard construction principles in interpreting the meaning of force majeure would be warranted. The Condition could have included modifications to the meaning of force majeure, but instead the cross-reference was made to force majeure under the STC without amendment. Therefore, we do not consider it appropriate to ignore express words in the force majeure definition.

⁶ Electricity System Operator Incentives 2011-13: Income Adjusting Events Determination: <https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-incentives-2011-13-income-adjusting-events-determination>.

31. As a result, the STC and the Condition should be interpreted consistently; the situation should not arise where an event constitutes force majeure under the STC, but not under Limb (a) (and vice versa). There is an express and clear requirement in the definition of force majeure under the STC that there must be an event or circumstance which results in or causes the failure of the Licensee to perform any of its obligations under the STC. This interpretation is in accordance with the position in law that a force majeure provision will usually be inapplicable where alternative methods of performance still exist. Additionally, we understand that cable failure has not previously been treated under the STC as a force majeure event. The approach adopted by the STC is therefore consistent with the fact that Service Reductions are a regular occurrence in the usual course of operating a transmission system.

32. We note the Licensee's argument that it is less clear why there needs to be a failure to perform an obligation under the STC in relation to a mechanism to quantify loss or gain (as opposed to the suspension of that obligation). However, the distinction between an event that causes non-compliance with the STC and an event that continues to allow the Licensee to comply with the STC nevertheless serves to demarcate the most serious from less serious events, and thus performs an important role in the context of identifying those events which are exceptional, such that a Licensee's loss may be passed on through the IAE mechanism.

33. We do not consider our approach to be inconsistent with the Moyle Interconnector Decision, as the Licensee asserts. In that decision, Ofgem did not indicate that the failure of a party to perform any of its obligations under the relevant code is irrelevant, nor did the decision contain any consideration of that specific provision. Ofgem made brief statements that the relevant event could "possibly" or "arguably" constitute force majeure but, as the decision wasn't made under the equivalent provision to Limb (a), it did not need to carry out further analysis on the facts or determine this point.

34. In summary, the Licensee has not identified an obligation that it has in fact failed to perform under the STC as a result of the Event; therefore, the Event does not satisfy the definition of force majeure under the STC.

Fault or failures caused by non-adherence to Good Industry Practice are not force majeure events

35. While the above is dispositive of the Licensee's claim under Limb (a), for completeness we have also considered whether the Event was beyond the reasonable control of the Licensee for the purposes of Limb (a) of the Condition.

36. While the Event constitutes a fault or failure in plant or apparatus, the Event also has to be beyond the reasonable control of the Licensee for the purposes of the STC definition of force majeure. The force majeure definition expressly provides that a fault or failure that could have been prevented by Good Industry Practice will not be beyond the Licensee's control.

37. 'Good Industry Practice' under the STC is defined in Section J, paragraph 3, as follows:

in relation to any undertaking and any circumstances, the exercise of that degree of skill, diligence and prudence and foresight which would reasonably and ordinarily be expected from a skilled and experienced operator engaged in the same type of undertaking under the same or similar circumstances.

38. The Licensee has failed to satisfy us, the burden resting upon the Licensee, that the fault in the case of the Event was not preventable by Good Industry Practice. To the contrary, the evidence we have seen indicates that the failure in the case of the Event was likely to have been preventable by Good Industry Practice. The Technical Report provided by the Licensee indicates that the cause of the Event seemed to be mechanical damage during storage or the coiling process (discussed further in paragraph 46 below). However, it was not possible to say precisely when the damage had occurred.

39. There is no suggestion that the fault or failure was caused by *the Licensee's* failure to follow Good Industry Practice. However, the proper construction of the force majeure provision is not concerned solely with the Good industry Practice of the Licensee:

- a) the Licensee is deemed to have been the party that carried out the development works by paragraph 6.3, Section G of the STC; in consequence, both the Licensee's and the developer's Good Industry Practice are relevant⁷;
- b) further, the STC definition of force majeure expressly excludes '*performance or non-performance by an Other Code Party*' as being a cause beyond the reasonable control of the applicant Party. As a matter of the proper construction of the force majeure clause, this supports an interpretation that force majeure under the STC is not intended to apply to mere breaches of contract by third parties.

40. Therefore, in determining whether or not an event was preventable by Good Industry Practice for the purposes of the STC definition of force majeure, we consider that the failure to abide by Good Industry Practice by other third parties involved in the

⁷ We note that paragraph 6.3, Section G of the STC applies to the Licensee because that provision applies to "generator build" projects, which include Gwynt y Mor. See the CA046 Modification, which introduced paragraph 6.3 in section G of the STC: <http://www2.nationalgrid.com/UK/Industry-information/Electricity-codes/STC/Modifications/Concluded-STC/>

construction of the transmission assets (for example a cable manufacturer or installer) is also relevant. We note that there is also a clear policy rationale for such an approach. In circumstances of a third party failing to follow Good Industry Practice, the OFTO should rely on any contractual remedies in respect of the breach, rather than seek protection under Limb (a) of the Condition. [REDACTED]

[REDACTED] This lends support to our view that the failure in the case of the Event is likely to have been preventable by Good Industry Practice.

41. We are aware that the Authority has accepted that the Event was beyond the reasonable control of the Licensee for the purposes of an exceptional event under Amended Standard Condition E12-J1 (the "**EE Condition**").⁸ However, we do not consider there to be any inconsistency between that decision and the present decision. The definition of an exceptional event in the "**EE Condition**" is similar to, but importantly different from, the definition of force majeure under the STC; in particular, the provisions relied upon for excluding third party default in the context of force majeure (see paragraph 39 above) are not present in relation to the exceptional event condition. Moreover, the Condition and the EE Condition are pursuing different aims. The EE Condition forms part of a performance mechanism in the Licence, which aims to incentivise the Licensee properly to maintain the transmission assets over the 20 year revenue period, and thus assesses whether the licensee itself has acted appropriately. In contrast, the Condition allows adjustments to the allowed revenue for costs incurred by an OFTO for certain events or circumstances that were not and could not have been predicted at licence grant. Given these different purposes, it is unsurprising that construction of the EE Condition could extend to events not covered by the definition of force majeure under the STC for the purposes of the Condition.

Limb (c) of the Condition

42. In assessing whether an event or circumstance is an IAE under Limb (c), we have considered, consistent with the BTLAL Decision, the balance of risk and whether the Licensee is the most appropriate party to manage the risk of the event. To determine this, we have considered the extent to which the Licensee was, or should have been, in a position to foresee the event or circumstances and the level of control it had to mitigate the impact of such event.

⁸ A copy of the decision is available here: <https://www.ofgem.gov.uk/publications-and-updates/gwynt-y-m-r-ofto-plc-direction-under-paragraph-10-amended-standard-condition-e12-j4-0>.

43. We considered the following factors:

- a) whether the Licensee knew of the event or circumstance before it arose or ought to have known of it;
- b) whether the risk of damage of that type was reasonably foreseeable (even if the particular way in which the damage has occurred may not have been);
- c) whether there are nevertheless exceptional factors in the relevant case that mean that the event or circumstance, or its consequences, could not have been reasonably foreseeable; and
- d) the ability of the Licensee to manage the risk or impact by putting in place and pursuing risk management arrangements such as insurance, commercial recourse against third parties and/or operating practices.

44. As noted in the BTLAL Decision, we consider that such an approach is consistent with the overarching design of the Offshore regime and with the Authority's statutory duties, in particular its principal objective to protect the interests of existing and future consumers in relation to electricity conveyed by transmission systems.⁹ For example, we do not consider it to be in the interests of consumers¹⁰ to pass through those costs arising from a type of damage that was (or should have been) foreseeable to a bidder/OFTO, solely because the precise damage of that type that occurred was not foreseeable; we therefore consider it appropriate to adopt a narrower, rather than a broader, construction of Limb (c) in this regard. Such an approach also seeks to ensure that bidders are properly incentivised to conduct due diligence in respect of the assets, to put in place appropriate commercial arrangements prior to asset transfer and to pursue any relevant third parties who may be liable (such as developers, manufacturers, installers, and insurers). The OFTO regime facilitates commercial transactions for large-scale infrastructure investment. We consider that the OFTO is responsible for managing its investment including adopting what it considers are suitable risk management measures.

Determination on whether the Event constitutes an IAE under Limb (c)

45. The Authority has decided that the Event does not constitute an event or circumstance that is an IAE pursuant to Limb (c).¹¹ The Authority considers that the risk of the Event

⁹ Section 3A of the Electricity Act 1989.

¹⁰ Whilst we recognise that the charging regime may in part or whole allocate costs for IAEs to offshore windfarm developers, we refer to consumers bearing these costs in the sense that all costs passed through into network charges are ultimately borne by consumers through their energy payments.

¹¹ For the avoidance of doubt, the Authority also does not consider that the Event constitutes an IAE under subparagraph 15(b) of the Condition.

was foreseeable and that the Licensee is the most appropriate party to manage the risk of the Event. The reasons for this decision are as follows:

Whether the Licensee knew of the event or circumstance before it arose or ought to have known of it

46. In relation to the Event, the Technical Report found evidence of mechanical damage to a copper conducting cable and the fibre optic cable running alongside it. The report noted that *the "outer serving and steel armour wires of the cable in the vicinity of the damaged lead sheath did not show any signs of mechanical damage. This suggests that the lead had sustained damage during the cable manufacturing/laying up process [A]n opportunity exists for damage to the cores to occur during laying up, during coiling onto the carousel, while moving between the laying up and armouring machines and while pulling off the carousel and into the armouring machine. Any damage at any one of these stages would not be visible after the armour had been applied".*¹² This damage would have occurred before the cable was laid on the sea floor.

47. We understand that the due diligence undertaken and the systems and processes in place to monitor the transmission cables had not identified the specific fault. On the facts, the Authority does not consider that the Licensee could reasonably have known about the *specific* fault that arose in relation to the Event. This is consistent with our determination of the Event under the EE Condition.

Whether the risk of damage of that type was reasonably foreseeable

48. The Authority considers that risks arising from defects in the construction of the transmission assets are reasonably foreseeable risks associated with operating the assets over the 20 year revenue period. We consider that failure of the cable arising from the actions or inactions of parties involved in undertaking the manufacture or installation of the transmission assets, i.e. a latent defect, is the type of risk that is reasonably foreseeable to a licensee and should be within its contemplation when it submits tenders under the generator build regime, however such defect may materialise.

49. The Licensee states that the best available information on cable risks at the time of their bid for the Licence was provided by CIGRE.¹³ The Licensee notes that, on the basis of certain assumptions, an average of one failure every 101 years per cable would apply in the Licensee's case. We note that the Licensee considered that, subject to its assumptions being correct, this information indicated a low probability rate of internal cable failure per

¹² [REDACTED]

¹³ CIGRE Technical Brochure 379, Update of Service Experience of HV Underground and Submarine Cable Systems, April 2009.

cable, and it was the Licensee's choice to base its risk management strategy on the conclusions of this data.

50. The Licensee has suggested that Ofgem, in its published material at the time, supported its assumption that the relevant cable risk required to be addressed by OFTOs was external damage/interferences to the cable rather than internal cable failures. The Licensee has not produced any evidence of such a statement. In any event, such a position is (and would have been) inconsistent with the intent of the OFTO regime. For example, the invitation to tender document for the Gywnt y Môr Licence makes clear that the risk of a 'major failure event' required to be addressed by OFTOs includes internal cable failures.¹⁴ We have also noted indications in the bid submitted by the Licensee that, whilst it may have considered the risk of an internal cable failure to be a low risk, it was one that it identified and contemplated in formulating its bid. The Licensee addressed its approach to repair costs arising due to a major failure event including any internal cable failures. It follows that the Licensee contemplated the risk of internal cable failures at the time and such failures were a type of risk that was foreseeable.

Whether there are exceptional factors in the relevant case that mean that the event or circumstance, or its consequences, could not have been reasonably foreseeable

51. On the facts of the claim, we do not consider that there are exceptional factors relating to the Event that mean that the Event or its consequences could not have been reasonably foreseeable.

The ability of the Licensee to manage the risk or impact by putting in place and pursuing risk management arrangements such as insurance, commercial recourse against third parties and/or operating practices

52. Similar to any other transaction involving a purchase of assets, a licensee should enter into such transactions with the awareness that it is assuming any risks arising from damage or defects that it has not been able to discover through its due diligence. The Offshore regime was not designed to insulate licensees from all such risks.¹⁵ Even if a licensee believes, having conducted a reasonable level of due diligence, that the construction of the assets had been undertaken properly and to the level of reasonable skill and care expected, we do not consider it appropriate for the licensee to be able to pass on the risks arising from defective work in the construction of the assets to

¹⁴ In the 'Invitation to Tender Document for the Second Transitional Tender Round: Gywnt y Môr Project' questions 4A and 8A ask the bidder how they would cover the financial consequences of a Major Failure Event. Major Failure Event means "failures that result in long repair times for a single item of equipment (for example cable or transformer), a fault, design or installation fault or other events (for example fire) that results in long repair times;".

¹⁵ The framework for the Offshore regime also reflects this through the STC which deems the OFTO, for the purpose of the STC, to have been the party that developed the transmission assets from the point of asset transfer (paragraph 6.3 of Section G) – see paragraph 39(a) above.

consumers. On the facts of the claim from the Licensee, we note no exceptional circumstances to alter this view.

53. We expect licensees to pursue third parties for remedies in respect of their negligent or below standard work and to put in place other commercial arrangements and risk management practices to ensure they can bear the consequences of such risks in the event there may not be any such recourse.

54. We also expect licensees to put in place appropriate insurance arrangements to manage risks and satisfy themselves that the insurance cover is suitable for their needs. We note that the Licensee took out an insurance policy that it believed would cover the costs of repair arising as a result of such a cable failure (under its 'operating all risk' policy with a LEG2¹⁶ exclusion). This was a commercial decision it made at its own risk, and our understanding is that 'operating all risks' insurance cover at LEG3 level was available in the market at the time the Licensee bid for the Licence. [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] In general, we do not consider it appropriate for consumers to bear a risk that arises due to the interpretation of commercial arrangements between the Licensee and third parties.

55. The Licensee also made representations about the level of insurance cover obtained for the Humber Gateway OFTO, but we do not consider these representations to be relevant to its claim in respect of Gywnt y Mor. Further, the Licensee notes that Ofgem did not identify that the proposed level of insurance cover for Gywnt y Môr was unacceptable. However, Ofgem's evaluation of the Licensee's proposed insurance arrangements as part of the tender process is solely for the purposes of scoring for the tender and making a preferred bidder selection. Ofgem does not thereby endorse a bidder's insurance proposals.

Conclusion

56. In summary, there is nothing in the information provided that suggests to the Authority that the risk of the Event was of a type so unforeseeable or exceptional that a prudent licensee would not have contemplated that risk in assessing the project prior to submitting its tender or fixing the revenue entitlement. We note that the Licensee may be able to recover only part of the costs incurred through commercial arrangements. However, whether or not the Licensee can recover any or all of the costs it incurred through

¹⁶ London Engineering Group 2.

commercial arrangements, the Authority considers that the Licensee is the most appropriate party to manage the risk of the Event.

Licensee's representations on the wider implications for the OFTO regime

57. In consultation, the Licensee raised various broader concerns about our proposed determination and its consequences for the OFTO regime.

Consistency of Ofgem's approach

58. The Licensee considers that this determination constitutes a retrospective shift in policy. The Licensee claims that, consistent with how the OFTO regime was presented by Ofgem and statements made by Ofgem, "construction risk" should not be passed to the Licensee under the transitional generator build model. We note that when the offshore transmission regime was put in place, the transitional generator build model was described as one where the OFTOs do not bear "construction risk" – this was in contrast to the OFTO build model which was intended, at the time, to be the main and enduring model going forwards. However, as the wider context in which this phrase was used made clear, this did not mean that the OFTO does not bear any risk from a defect in the construction of the assets. Any statements made in relation to "construction risk" were made in the context of describing fundamental differences between the OFTO build model and the generator build model, and also in the context of the OFTO not constructing the assets under the generator build model.
59. As stated in the BTLAL Decision, an overarching premise of the generator build model was that the developer bears the risks associated with construction of the transmission assets, such as increased costs from construction overruns and the failure to complete the assets on time during the construction phase. In contrast, the OFTO is responsible for owning and operating the transmission assets¹⁷ from the point of asset transfer, and for the associated risks arising from ownership of the assets. The Offshore regime was not designed to insulate OFTOs from all risks that could somehow be traced back to the construction of the assets such as a latent defect.
60. The Licensee considers that it purchased the assets on the basis that construction of the assets was economic and efficient and the assets were fit for purpose. The Licensee notes that it assumed at bid stage that the developer followed good industry practice in constructing the assets. We consider it is the Licensee's responsibility to carry out the relevant due diligence and establish whether it is satisfied with the state of the assets. The Licensee notes that we based the transfer value of the assets on the principle that the assets were efficiently constructed and were complete, and disallowed inefficient

¹⁷ Note that under the "OFTO build" model, the OFTO bears construction as well as operating risk.

expenditure by the developer. Our published guidance on the cost assessment process states that “we first consider whether costs have been appropriately allocated ... we then consider whether the costs ... have been incurred in an economic and efficient manner”.¹⁸ Therefore, the cost assessment process does not certify whether the assets are efficiently constructed, complete and fit for purpose – rather, the process seeks to safeguard that consumers do not bear costs of inefficient expenditure by the developer. It is not Ofgem’s responsibility to identify defects in, or verify the fitness for purpose of, the assets in setting the transfer value.

61. The Licensee notes that, in certain cases, the Authority has provided a bespoke ‘Contingent Event Adjustment’ (“CEA”) term in OFTO licences to address potential costs and expenses arising from known but unpredictable factors at the time the licence is granted to an OFTO. However, provision of such a CEA does not in any way determine the interpretation of the IAE to be applicable to all ‘unknown unknowns’ as the Licensee asserts.
62. The Licensee has also referred to a draft letter dated April 2013 from Ofgem in relation to another project, which letter was never finalised, in which the draft stated that “if a Cable Issue was to materialise we may consider it to be an income adjusting event if the relevant Offshore Electricity Transmission Licence requirements were satisfied”. Even if such a letter had been finalised and sent to the Licensee, it makes clear that the question of whether there is an IAE is highly fact-specific and dependent on the conditions in the Licence being satisfied. We therefore do not consider that this draft letter constrains our approach in this determination.

Future Consequences of this Determination

63. The Licensee noted various concerns on the wider implications of this determination on the OFTO regime. In particular, the Licensee is concerned that:
- the determination may result in increased TRS bids for future projects;
 - financing for projects is likely to be more expensive;
 - current OFTOs will be fully exposed to further costs of repairs for similar failures (which it may be unable to fund);
 - bidders on future tender rounds will be forced to push the risk of internal cable failures to the developer as risk cannot be fully mitigated through insurers (lack of insurance coverage) or construction contracts (as defect remedies are limited in time and amount) which will lead to delays in closing projects; and
 - OFTO projects will find it more difficult to secure investment grade credit ratings.

¹⁸ Paragraph 2.2 of the Offshore Transmission Guidance for Cost Assessment 2012
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/cost-assessment-guidance_0.pdf

64. We have considered the potential wider implications for the OFTO regime as a result of this determination where relevant. In our view, this particular determination should not materially impact future OFTO tenders. We consider that the regime will continue to bring benefits to consumers by providing long term visibility on transmission costs through a competitive procurement process. Further, to address the issues covered in this determination, we believe it is incumbent on developers to work actively with OFTOs to ensure future issues are prevented through good practice in project development. We are keeping a watching brief on developments occurring in the industry regarding offshore transmission assets.

65. We acknowledge the Licensee's suggestions as to measures that could be put in place to address the perceived current and potential future uncertainties facing the OFTOs. This determination, together with our determination on the IAE claim from Thanet OFTO Ltd and the BTLAL Decision provide some clarity as to Ofgem's approach to claims under the Condition.

66. This letter also constitutes our decision for the purposes of paragraph 23 of the Condition.

Yours sincerely,

Akshay Kaul
Partner, Competitive Networks

For and on behalf of the
Gas and Electricity Markets Authority

