

OFTO SALES – AVOIDING THE PITFALLS

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FIRST: A DISCLAIMER AND A RECAP

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Ofgem's consultation on the current tender round was published in November 2020 and initially open for responses until 8 January 2021, as set out in a previous article in this series¹. That deadline was extended to 22 January 2021, and so we find ourselves still waiting² for Ofgem to publish its response and set out any changes to the process. Notably, the consultation did ask questions about the process of finalising the transfer documentation, and so our focus here is on more substantive issues, though readers should certainly keep an eye out for process changes.

For those who are less familiar with the OFTO process, a generator ("developer", to use the language of the legislation) approaches Ofgem and requests that Ofgem runs a tender exercise for the sale of its transmission assets once they have been built. Ofgem runs a tender exercise involving three or more stages³ to choose a successful bidder to whom it will grant an OFTO licence. In parallel, the developer prepares the sales documentation (the focus of this article) against which bidders carry out their due diligence and submit their bids, and Ofgem determines the recoverable cost of

the transmission assets, which is inserted into that documentation. This creates a different dynamic to most sale and purchase transactions; this is considered in more detail below.

IN THE BEGINNING: HOW THE OFTO SALE AND PURCHASE AGREEMENT DEVELOPED

The sale and purchase agreement entered into between the developer and the OFTO (the "OFTO SPA") is one of the key documents in an OFTO transaction and sets out the terms on which the OFTO assets will be transferred by the developer to the OFTO. Referred to as the "transfer agreement" in legislation and Ofgem's guidance, the OFTO SPA can be structured for an asset sale or share sale.

For the first tender round (“TR1”), Ofgem published a model transfer agreement to be populated by qualifying developers. While it was used as a basis for TR1 OFTO sales, it took the form of guidance only for subsequent tender rounds, with Ofgem recognising that the parties to the transaction were better placed to understand the quirks of each project and to draft the relevant documents. While Ofgem does review the OFTO SPA as part of the OFTO tender process, it does so mainly to ensure no inconsistencies with the regulatory regime, recognising that the OFTO SPA is “*a matter for the parties to commercially agree*”⁴.

To date, all OFTO transactions have been structured as a sale of assets rather than a sale of shares, making it particularly important to ensure that the OFTO SPA includes a definitive list of the OFTO assets and construction contracts. Given that this is also required by Ofgem’s cost assessment process, it should not require too much extra work for developers.

While a share sale is envisaged by the legislation, and would perhaps result in a neater OFTO sales process with fewer third parties involved who could potentially cause delays to novations and assignment of contracts, projects have not been set up in this way. This may be because of economies of scale requiring developers to contract in their own names (as discussed in our previous article on large complex projects), or it may simply be because setting up a shell project company adds an extra layer of complexity (whether for financing, tax treatment or other considerations) that developers shy away from.

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Whatever the reason, in this article we share some practical tips and insight around an asset sale OFTO SPA based on WFW’s experience of advising on many OFTO transactions across various tender rounds, including (among others) Walney Extension, Race Bank, Galloper and Burbo Bank.

The dynamics to the negotiation of an OFTO SPA are quite different to a normal M&A deal. From the developer’s perspective, there is no ongoing competitive tension as it cannot threaten to approach alternative purchasers. For the OFTO, as issues are identified during due diligence, it also cannot walk away or easily resort to price chipping. The final transfer price will largely be fixed (as determined by Ofgem) and any changes to the OFTO’s tender revenue stream will require justification and Ofgem consent. Whilst tender revenue changes can potentially be agreed, the primary solution will be to seek contractual protection in the OFTO SPA. As the end of the generator commissioning period approaches, it creates additional pressure on the developer to settle and close the transaction and avoid the risk of committing a criminal offence or having to shut down the wind farm.

PREPARATION, PREPARATION, PREPARATION

As a developer obtains property rights and contracts for construction of the wind farm and the transmission assets (which will be divested to an OFTO in due course), the burden (and opportunity) to prepare for a smooth OFTO process will fall on its shoulders. A key factor in helping ensure a smooth-running and efficient OFTO transaction process is good preparation. This is beneficial in two key ways:

- helping avoid problems in the future once qualifying projects have been tendered and the OFTO SPA negotiation process starts; and

- managing time as the generator commissioning period has usually begun during, if not before, the ITT stage, leaving the developer with 18 months to complete the sale process (see our earlier article on the impacts of the 18-month period).

The OFTO will be purchasing the physical OFTO assets and the underlying contracts relating to these assets. It is therefore extremely important that the relevant project/procurement teams are aware of the OFTO transaction process and that these contracts are entered into with this in mind. This includes:

- when structuring the contracts for the offshore wind farm, some consideration will need to be given to how the OFTO assets will be disposed of – in particular, the need to show that costs were “economic and efficient” to recover the full build cost of the OFTO assets in the OFTO process;
- ensuring that contracts which relate to both OFTO assets and developer assets can be split so that the OFTO can receive the benefits in respect of the OFTO assets and the developer can retain the benefits in respect of the developer assets;
- ensuring that contracts which relate solely or mainly to the OFTO assets include provisions permitting novation to the OFTO to hopefully speed up the negotiation process with counterparties at the time of the OFTO transaction. The relevant contracts usually include a template form of novation agreement (although it may be that the OFTO has comments or wants input on the terms);
- ensuring confidentiality provisions in the project agreements allow disclosure of sufficient information (both technical and contractual) to OFTO bidders in the data room at bidding stage to minimise any confirmatory due diligence needed at preferred bidder stage; and
- maintaining up-to-date contact details for contract counterparties to ensure that at the time of the OFTO SPA negotiations, the developer can quickly get in contact with the right people to help facilitate speedy negotiation of the assignment/novation documents.

Any gaps identified in the information provided during the OFTO process, or any issues that are uncovered may result in developers providing specific indemnities in the OFTO SPA, in addition to or over and above the usual snagging provisions for projects that have just been commissioned. Accordingly, good preparation and early action to resolve issues should smooth the path of negotiations.

Another consideration may be the role that the site visit plays. For the most part, site visits are saved for the preferred bidder stage. This is in large part owing to the practicalities and health and safety implications of hosting visitors to offshore substations; the OFTO process would allow site visits during an ITT stage, for example. While there is extra time and work involved for developers in facilitating this, they may consider it worth their while if issues can be reflected in the OFTO SPA while competitive tension still exists.

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LIABILITY CAPS

So where do we see the development of the OFTO SPA going forward?

As noted in our article on ever larger projects, the scale of offshore wind projects has increased exponentially since the first projects that were included in TR1. Projects in TR1 mainly ranged in size from 90 MW to 315 MW, with the largest project coming in at 500 MW. TR7 was announced by Ofgem on 12 November 2020, with the two projects taking part clocking in at 900 MW and 857 MW.

The OFTO SPA will typically include a general cap on the developer's liability which will usually apply for all liabilities other than title warranties. In some of the early tender rounds, this general cap was set at 20%, as can be seen in the publicly available bond listing information for Greater Gabbard (a TR1 project)⁵ and Gwynt y Môr (a TR2 project)⁶. In subsequent tender rounds involving larger projects, the general caps have been an area of focus for developers looking to limit their ongoing financial exposure and free up capital. Downward pressure on the level of the general cap means that OFTOs can become particularly sensitive to any material risks identified during the due diligence process and the extent to which any related liabilities should fall within or outside the general cap.

Ofgem's most recent transfer agreement guidance⁷ sets out general principles for developers and bidders to consider. While it does not dictate commercial positions, it recognises some sensible principles⁸ that developers would do well to take heed of:

- No specific levels for caps are set out, but *"Ofgem encourages Developers to consider the impact insufficient warranty protection may have on the Qualifying Bidders' TRS Bids"*; and
- Bidders *"may have concerns about the creditworthiness of the selling entity"*, and developers should therefore *"consider offering Security for the obligations of the vendor under the Transfer Agreement"*.

It will be interesting to see what effect (if any) the impact of even larger projects with final transfer values significantly exceeding £1bn will have on the level of liability caps and the form of security developers (particularly consortia) provide.

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TREATMENT OF SHARED INFRASTRUCTURE

As multi-phase projects become more and more common, with ambitious targets for deployment of offshore wind, a key consideration in structuring an OFTO sale will be the use of shared infrastructure. Clearly, this will have an impact both on price (determined by Ofgem) and on the OFTO SPA. For example, if an onshore substation is oversized to cater for a later phase of development, the developer has several choices: sell the OFTO a leasehold for part of the building rather than the freehold for the whole site; sell the freehold for the whole site and take back a leasehold of part of the building (to be sold on to another OFTO in due course); or some other arrangement that achieves a suitable division of interests and rights.

Equally, an offshore substation could be oversized to cater for an expansion to the offshore wind farm (and eventual sale of rights to another OFTO), or for access and maintenance to an existing offshore wind farm (for example by addition of a helipad

or other equipment to facilitate maintenance).

GETTING THE DEAL DONE

Commercial and technical realities need to be reflected in the OFTO SPA. This needs close cooperation between developer transaction and technical teams, as set out above, with the same required for OFTO bidders and their funders, supported in each case by a team of specialist advisors. WFW's multi-disciplinary team is specifically structured to ensure that our sector specialists can work together closely to provide a seamless service to our clients. We have experience advising on successful OFTO transactions, and also in providing training sessions to developer project teams and OFTO bidder teams on preparation for the OFTO transaction process.

Please do get in touch to discuss your OFTO transaction needs.

To opt in to WFW mailings and register for alerts on our forthcoming articles as soon as they are published, please email us **here**. All the articles published in our OFTO series can be found **here**.

[1] <https://www.wfw.com/articles/a-review-of-the-ofto-regime-yes-please/>

[2] As at 16 February 2021.

[3] An enhanced pre-qualification stage (that may be split into a pre-qualification stage and a qualification to tender stage), an invitation to tender stage, and a preferred bidder stage.

[4] https://www.ofgem.gov.uk/sites/default/files/docs/2009/07/model-spa-and-commentary_0.pdf

[5] <https://www.ise.ie/Market-Data-Announcements/Debt/Individual-Debt-Instrument-Data/Dept-Security-Documents/?progID=-1&uID=4911&FIELDSORT=docId>

[6] https://www.ise.ie/debt_documents/Prospectus%20-%20Standalone_b7220d81-cd2b-4d13-8ec0-3d296f634613.PDF

[7] Pages 57 and 70,
https://www.ofgem.gov.uk/system/files/docs/2020/12/tender_process_guidance_document_november_2020.pdf

[8] Ibid, Page 78.

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