

NeuConnect Britain Limited,  
electricity interconnector  
licensees, and other interested  
parties

Email: [cap.floor@ofgem.gov.uk](mailto:cap.floor@ofgem.gov.uk)

Date: 21 July 2023

Dear stakeholders,

### **Preliminary cap and floor levels for the NeuConnect interconnector to Germany**

In May 2020, we published a decision to enable project finance solutions for two cap and floor projects, Greenlink and NeuConnect. The project developers requested changes to our cap and floor regime to broaden the sources of financing available for them to progress their projects through construction.<sup>1</sup>

One of the changes we approved was to set the floor level based on either of the two alternative approaches below:

- **Approach 1:** Notional approach using *UK Non-financial iBoxx BBB 10+ years* as the relevant debt index with everything else remaining the same as in the default regime (such as paying the notional cost of debt on 100% of the Regulated Asset Value (RAV)); or
- **Approach 2:** Market-based approach using an actual cost of debt and gearing that result from a competitive debt raising process and introducing a mechanism for developers to repay consumers any extra cost over *Approach 1* if the overall cost under *Approach 2* is higher. This floor level is set to allow repayment of debt only, and shareholders are not allowed to recover invested equity or a return on it at the floor level set based on *Approach 2* (Actual Floor Level).

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<sup>1</sup> <https://www.ofgem.gov.uk/publications/decision-proposed-changes-our-electricity-interconnector-cap-and-floor-regime-enable-project-finance-solutions>

Our 2020 decision gives developers the option to choose between Approaches 1 and 2 above. Special Condition 3, paragraph 3 of the NeuConnect Britain Limited (NBL) licence allows NBL to notify us of its elected approach within 10 days of their financial close.

### **Final Project Assessment (FPA) decision for NeuConnect**

In April 2022, we consulted on the efficient costs for the NeuConnect interconnector.<sup>2</sup> In July 2022, we set the GB share of NeuConnect’s development, capital, and operational expenditure during construction costs at £989.0m in nominal prices.<sup>3</sup> For its operational phase, we set NeuConnect’s operating expenditure (opex), replacement expenditure (repex) and decommissioning costs at £572.9m in real 2020/21 prices.<sup>4</sup> We noted that these costs would be converted into cap and floor levels based on financial parameters using a reference date of Financial Close or Final Investment Decision date. Parameters such as the actual cost of debt and gearing are inputs for calculating the actual floor level, while parameters such as notional cost of debt and gearing are inputs for the notional cap and floor levels.

### **Debt financing process and financing parameters**

We summarise our oversight of the process undertaken by NBL to secure debt finance, leading to financial close on 27 July 2022. Our oversight process was designed to protect consumer interests while not unduly delaying the delivery of the interconnector. The oversight covered four key areas:

1. **Market sounding process** – this covered the approach taken by NBL to assess market appetite for the project from commercial, non-commercial lenders and other lending institutions. NBL provided key risks and characteristics of the transaction to more than 50 banks and institutional investors. The type and identity of the commercial lenders approached by NBL was consistent with those seen on recent Offshore Transmission Owner (OFTO) and interconnectors transactions.

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<sup>2</sup> <https://www.ofgem.gov.uk/publications/consultation-final-project-assessment-neuconnect-interconnector-germany>

<sup>3</sup> <https://www.ofgem.gov.uk/publications/decision-final-project-assessment-neuconnect-interconnector-germany>. Please note that pre-operational costs approved in this publication are entitled “2022 prices”, reflecting the date of their submission to Ofgem, rather than their acceptance as real values. We have therefore treated these costs as nominal costs for the purposes of deriving the preliminary cap and floor levels. NBL has notified Ofgem that the ‘opex during construction’ portion of the £989m should, in their view, be real 2020/21 prices. Ofgem will consider this point at PCR based on evidence NBL can provide at that time.

<sup>4</sup> Please note that relevant post-construction costs detailed in the FPA decision are entitled “2022 prices”, which reflected language used in NeuConnect’s FPA submission to mean real 2020/21 prices, submitted in 2022.

NBL provided Ofgem with a summary of the market sounding process. Based on an analysis of the market sounding feedback, NBL decided to pursue a hybrid fixed and floating rate financing option. NBL also decided to pursue a bank-financed option, rather than using institutional investors. This was based on NBL's view that it could attract sufficient funding on competitive terms. To narrow the range of pricing, NBL proposed a set of consensus terms, which led to some lenders dropping out of the process due to tighter pricing and proposed tenor. Lenders who agreed to the aligned terms were invited to the next steps of the financing.

2. **Market launch process** – this stage involved the sharing of more information on the project with the selected group of potential lenders. This covered the Information Memorandum (IM), a financial model (FM), a long form termsheet or draft Facility Agreement (FA), and due diligence reports prepared by lenders' advisors – including technical, insurance, revenue etc. The IM and audited FM prepared by NBL and its financial advisor were comprehensive and typical for a transaction of this type. NBL provided sufficient information to inform the credit approval process of potential lenders.
3. **Credit response process** - NBL provided a summary of lenders' responses to the credit process to Ofgem. A majority of commercial banks included in the market launch responded positively and were able to obtain necessary credit approval to remain in the process. NBL discussed with Ofgem the principle for selecting the final lenders group. Ofgem provided necessary clarification on the Preliminary Actual Floor Level to enable the final lenders group to complete their due diligence.

NBL was able to secure liquidity in excess of the debt financing package, which helped to reduce any pressure to raise margins. The final pricing saw a reduction of 20bps in the margin for the construction period and a 5-10bps reduction in margins for the operational period. Long-form documentation was negotiated and finalized ahead of dry financial close.

NBL also secured Japan Bank for International Cooperation's (JBIC) and European Investment Bank's (EIB) participation in the transaction through separate facilities. Both institutions provided lower margins compared to the commercial facility.

4. **Financial close process** - carried the risk that the consumer benefit established by the debt competition could be eroded. NBL shared the financial close protocol and financial agreements for Ofgem's review. NBL also led a number of trial runs to ensure that the live financial close process would go as smoothly as possible. Ofgem

participated in the trial runs and the final financial close process. An independent audit report was provided to Ofgem on the final review of the project financial model to inform financial close.

### **Our view on the NBL debt raise process**

The process followed by NBL in selecting commercial banks has been appropriate for a transaction of this kind and when considering the nature of the transaction. NBL approached a wide range of potential lenders with appropriate levels of information, in a structured manner, which may be expected to drive competitive pricing behaviour. NBL managed the final lenders group well and applied appropriate pressure to further tighten terms. The participation of non-commercial lenders such as the JBIC and EIB and the debt package provided by JBIC contributed to a lower Preliminary Actual Floor Level.

To address concerns around non-commercial lenders withdrawing late in the day due to their unique credit approval process, NBL looked to secure commitments from commercial lenders for more liquidity than required to finance the project. While an understandable concern, securing the excess liquidity is likely to have increased the commercial debt costs. NBL noted that this approach was necessary to reach financial close within agreed timelines and to ensure that the project would not be delayed. A delay would prevent placement of EPC contracts as had been scheduled and prices could rise – potentially increasing the overall delivery cost. We consider this was an appropriate strategy given the potential scheduling and cost risks that could have materialised if financial close was not achieved.

### **Preliminary Cap and Floor (Notional and Actual) levels**

The financial parameters for the NeuConnect project have been confirmed following the conclusion of the debt raise process. This includes the actual gearing, debt and coverage ratio that underpin the calculation of the Preliminary Actual Floor Level for the project.

We have updated the NeuConnect Cap and Floor Financial Model (NCFFM1) published alongside our June 2021 decision to generate the preliminary cap and floor levels for the NeuConnect project.<sup>5</sup> The values for the Preliminary Notional Cap Level and Preliminary Notional Floor Level are based on project costs we approved at the FPA stage and financial parameters determined in line with the default regime. Project finance costs (including

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<sup>5</sup> <https://www.ofgem.gov.uk/publications/decision-changes-electricity-interconnector-licence-held-greenlink-interconnector-limited-gil-and-electricity-interconnector-licence-held-neuconnect-britain-limited-nbl>

capex cost increase between FPA and final EPC contract signing) and financial parameters determined at financial close underpin the Preliminary Actual Floor Level.<sup>6</sup>

**Our Preliminary Cap Level for the NeuConnect interconnector is £121.56 million. Our Preliminary Notional Floor Level is £71.11 million, and Preliminary Actual Floor Level is £83.95 million<sup>7</sup> in 2020/21 prices.**

The updated NCCFFM1 and model handbook (CFFMH1-ACOD) are published alongside this decision.

Following conclusion of its debt raise process and financial close on 27 July 2022, NBL notified Ofgem on 28 July 2022 of its election to use Approach 2 (as set out on page 1 of this decision) to set the floor level for the NeuConnect project. In line with Approach 2, consumers will top up revenues to the Actual Floor Level when necessary.

NBL must repay the difference between any floor payments based on Approach 2 and potential floor payments based on Approach 1 before shareholders can take any equity returns or dividends from the project. To be clear, we note that borrowing by shareholders or equivalent that may seem like a workaround for the restrictions on equity distributions or dividends payment will not be allowed.

If you have any questions in relation to this letter, please contact David Bell by email ([David.Bell@ofgem.gov.uk](mailto:David.Bell@ofgem.gov.uk)).

Yours sincerely,



**Stuart Borland**

**Deputy Director, Offshore Network Regulation**

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<sup>6</sup> Inputs underpinning the Preliminary Actual Floor Level in the NCCFFM1 are different from the corresponding inputs in the NBL project finance model. The NCCFFM1 inputs have been selected to ensure that the Preliminary Actual Floor Level it generates matches the actual cost of debt floor level generated in the NBL project finance model as have been agreed with lenders to the NeuConnect project.

<sup>7</sup> Ofgem-approved costs estimates, as set out in our July 2022 FPA decision, underpin the Preliminary Notional Floor Level. The project's signed EPC contract(s) costs and project-finance costs underpin the Preliminary Actual Floor Level. Any costs items not assessed at FPA will be assessed at the PCR stage to inform any necessary adjustment to the Preliminary Notional Floor Level.