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Offshore wind farm developers
and other interested parties

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Dear colleague

Decision on the interest during construction for offshore transmission assets

Summary

We consulted in July 2011 on an appropriate rate to allow offshore wind farm developers for the cost of financing transmission asset construction[1]. The proposals in that consultation were informed by the findings of a report commissioned from Grant Thornton (GT)[2]. The proposal set out in our July 2011 consultation was to cap the allowed rate at the bottom of GT's suggested range, namely a cap of 7.6% (pre-tax, nominal).

The consultation responses provided new information which we have taken into account. We have amended our conclusions to reflect the increased costs of debt and equity indicated by the consultation responses.

The consultation document also sought views on a number of other aspects of the interest during construction (IDC) issues (such as the period over which to apply it). There was broad support for our proposals in these other areas and consequently we are not proposing changes other than to the rate and the date of application.

As an outcome of the consultation, we have decided to retain a cap on the IDC rate which will:

- **(i)** **be set towards the middle of the range at 8.5% on a nominal pre-tax basis;**
- **(ii)** **apply prospectively from 1st December 2011;**
- **(iii)** **be subject to periodic review; and**
- **(iv)** **apply on the basis of a calendar period rather than a tender round.**

The remainder of this letter sets out a summary of the rationale for our decision and the responses to our consultation document dated 1 July 2011.

[1] The consultation document "Offshore transmission: Interest during construction for transitional tender rounds" (July 2011) and the non-confidential responses received are available on the Ofgem website at http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=28&refer=NETWORKS/OFFTRANS/PDC/CDR/CONS2011 Offshore transmission: Interest during construction for transitional tender rounds (July 2011)
[2] GT are our financial advisers for the second transitional round (TR2). Their report "Interest During Construction for TR2A offshore transmission assets" (March 2011) is available at: http://www.ofgem.gov.uk/NETWORKS/OFFTRANS/PDC/CDR/CONS2011/Documents1/Grant%20Thornton%20-%20Interest%20during%20construction%20for%20offshore%20transmission%20assets.pdf

Background

For the transitional tender rounds, the windfarm developers are responsible for building the transmission assets which connect the offshore wind farm to the onshore network. These transmission assets are then transferred to the successful Offshore Transmission Owner (OFTO) following the completion of a competitive tender process.

As part of the cost assessment process we assess the costs of developing and constructing the completed assets to ensure they are economic and efficient. This is provided for in regulation 4(1) of the Electricity (Competitive Tenders for Offshore Transmission Licences) Regulations 2010 which states that:

> "*In respect of a transitional tender exercise, the Authority shall calculate, based on all relevant information available to the Authority at that time, the economic and efficient costs which ought to be, or ought to have been, incurred in connection with developing and constructing the transmission assets in respect of a qualifying project...*"

The aim of providing IDC to developers is to recompense them for the economic and efficient costs of financing the development and construction of the transmission assets. The test of being 'economic and efficient' applies in respect of both the rate and the period. The interest rate is only applied up to the date transmission asset construction ceases. Should the programme for expenditure contain inefficient costs or inefficient delays it will not be applied to those costs or during those delays. The rate allowed for IDC will ultimately be borne by consumers.

We have previously capped IDC at 10.8 per cent

During the first transitional round (TR1) we considered what an appropriate cost of financing the construction of offshore transmission assets ought to be. We also considered whether there were reasonable grounds to impose a cap on the interest rate. We used our own internal assessment in conjunction with a report by our financial advisers (see E&Y report covering the period 2005-09[3]) to come to a view, based on the information available at the time, on the appropriate cost of financing. In April 2010 we wrote to developers in TR1 indicating we would apply a cap of 10.8 per cent for IDC on a pre-tax nominal basis for transitional tender round projects. This figure was applied retrospectively to all TR1 projects and was taken from the top of the range recommended by our advisers. This decision had regard to the uncertainty in the ongoing financial crisis and the impact it was having on the availability and cost of funds for projects.

We received updated analysis with a range of 7.6 to 9.7 per cent

We noted that during 2010 the liquidity of funding for projects had improved. In early 2011 we asked GT to examine the period 2009 to 2010 and provide their views on a suitable range for IDC. They advised that based on their analysis a cap should be retained. They also advised that an appropriate range for IDC would be 7.6 to 9.7 per cent to reflect the change in market conditions in 2009 and 2010.

We consulted on a cap of 7.6 per cent

In July 2011 we consulted on our minded-to approach to reduce the cap on IDC to the bottom of the range proposed by GT, ie 7.6 per cent, with effect from 1 September 2011. The previous cap of 10.8 per cent would apply until this date. This view reflected our then emerging expectation that the pace of recovery from the financial crisis would continue. It was proposed that this cap be applied to existing TR1 projects (to the extent that they are still under construction) and all TR2 projects, i.e. it would be a calendar based cap. Any

[3] Seewww.ofgem.gov.uk/Networks/offtrans/rott/Documents1/Appendix%206-%20EY%20report%20on%20IDC.pdf

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project requesting a lower forecast IDC than the cap will have their own rate applied to avoid consumers funding a figure above that incurred by the developers.

The consultation sought views on our minded to position in a number of areas:

Issue consulted upon	Minded to position in July 2011
Should we cap IDC at all?	Yes
Where should we set the cap?	At the bottom of the range, ie 7.6 per cent
What period should we apply the cap over?	A calendar period. Hence the IDC rate would be applied to all eligible projects for a specific time period regardless of the tender round that they are in.
When should we apply the new cap?	Prospectively from 1 September 2011
Should we review the cap?	Yes, we should review the cap and our overall approach to IDC as market conditions change

Respondents supported the principles but questioned the details

All respondents agreed that retention of a cap was appropriate to ensure the costs incurred are economic and efficient. A number of the respondents felt the cap should be more forward looking. They had mixed views on both our proposed approach to determining the allowable IDC and our preference for a calendar based cap. A major consumer representative supported our minded-to approach of implementing a cap at the bottom of GT's range. The developers however generally disagreed with the approach. Their main concerns related to a lack of clarity or justification for the chosen level of a particular component or group of components. The non-confidential responses are available on the Ofgem website in full and are summarised in Annex 1.

We noted the new evidence presented in the consultation responses

Many of the consultation responses highlighted new evidence which has a bearing on our decision on an appropriate level for the IDC cap. In particular several developers responded with comments about the costs of debt and equity which have allowed us to take an updated view on these values. Several developer respondents noted that current debt market conditions have worsened in the recent past, not least as a result of the ongoing sovereign debt crisis. Whilst the cost of debt for any given credit rating has decreased throughout 2011 the ongoing financial crisis is likely to lead to downward rating pressure on many companies. Consequently we feel it is appropriate to model a slightly lower credit rating when considering the cost of debt leading to a higher cost of debt.

Several of the same respondents also commented on the equity beta value we have used. Specifically they provided analysis which showed that for a company constructing offshore transmission assets it may be appropriate to model a higher beta value to reflect the risks involved. We acknowledge the inherently subjective nature of attempting to estimate the equity beta value, particularly when there are several different types of companies constructing offshore transmission assets. We also note that the construction risk involved in these transmission assets may be lower than a "traditional energy company" as the developer is not exposed to efficient cost or time overruns. However, in light of comments received we considered it appropriate to increase the cost of equity. The table below shows the revised position we felt it was appropriate to model for the IDC cap:

Factor	Value
Cost of debt (pre-tax, nominal)	5.9%
Cost of equity (pre-tax, nominal)	9.8%
Gearing	33.3%
Pre-tax WACC[4]	8.5%

[4] WACC is the weighted average cost of capital

We concluded it was appropriate to retain a cap

We have decided to retain and implement a revised cap on IDC of 8.5 per cent. This is towards the midpoint of the range proposed by GT. In making our decision we have had regard to two key factors. Firstly, stakeholder concerns in relation to the increased costs of debt and equity. We are of the view that the bottom of the range may not appropriately compensate developers for these increased costs. Secondly, a move towards the mid-point recognises the extra uncertainty of funding that became apparent in the financial markets during the summer from the disturbances over sovereign debt. We consider that this level of reduction from the current cap represents a fair balance between minimising the costs of renewable energy for consumers and compensating developers for efficient costs. We believe that the top of the range would not represent a fair balance of these costs. Furthermore our decision to retain a cap reflects our original minded to position and the consultation responses, which supported this position.

The new IDC rate of 8.5 per cent will be applied prospectively from 1 December 2011 on a calendar period basis. So, for the avoidance of doubt, all projects regardless of tender round will have IDC capped at 10.8 per cent up until 30 November 2011. From 1 December 2011 all projects regardless of tender round will have IDC capped at 8.5 per cent.

We remain committed to a periodic review of the cap and its methodology of calculation. The periodic updates will be performed when we feel that market conditions make it appropriate in order to ensure the IDC cap is fair and reflective of current conditions. We expect this update might typically be made annually though we reserve the right to determine the timing on a case by case basis.

Yours sincerely

Mark Cox
Associate Director, Offshore Transmission

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Annex 1 – Summary of responses to the consultation

The consultation elicited ten responses, one of which was confidential. One response came from a consumer group which supported the minded to approach. The remainder were from active or potential developers and the industry association. Of these a third contained a mix of views and two thirds contested specific points, in particular the use of the bottom of the range for a cap.

List of non-confidential responses

	Name	Industry Group
1	Consumer Focus	Consumers
2	Renewable UK	Trade Association
3	National Grid	Transmission operator
4	Centrica	Integrated energy company
5	Dong Energy	An existing developer
6	EDF Energy	Integrated energy company
7	E.ON	Integrated energy company
8	RWE	Energy supplier
9	Scottish Power Renewables	Wind energy developer and operator

Responses received by Ofgem which were not marked to be kept confidential have been published on our website www.ofgem.gov.uk and copies are also available from our library.

Responses by question

Chapter 2 Question 1: Do you agree that it is appropriate to retain a cap to put a limit to developers' claims on financing?

Eight respondents commented. All were supportive of a cap. They noted this was in line with Ofgem's primary duty of protecting the interests of current and future consumers. ***Ofgem has decided to retain the use of a cap***.

One respondent cautioned against having too stringent a cap because developers already have an incentive to make efficient investment decisions. The respondent noted that having a higher cap would also result in higher transmission network use of system charges (TNUoS) which the developer would bear.

Chapter 2 Question 2: Do you agree with the general approach to determining the allowable IDC as set out below?

All respondents commented on this question. The consumer representative and the majority of the integrated energy companies broadly supported the scope of IDC, in particular the duration and the coverage of items allowed.

Some respondents with a strong interest in developing wind generation disagreed with the applicable duration. They thought it should continue until the later of commissioning or transfer to an offshore transmission owner (OFTO).

We note that IDC is intended to give some relief for the cost of financing generation assets which are not yet capable of generating a return themselves because they are under construction. Hence once the assets are, or ought to be, generating a return (because, for

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instance, they are generating electricity) it seems appropriate to cease the IDC allowance. **Hence Ofgem consider a later date is not efficient.**

Two respondents felt that the cap should be set in real not nominal terms but there was little rationale provided to support this view. IDC is on actual cash expenditure which is nominal not real and primarily applies for a short period of capital expenditure (ie up to three years) and therefore we consider that the IDC rate should be in nominal terms.

One respondent sought to have the right to request a review of the rate in the event of a significant adverse change in financial market conditions. We are committed to reviewing our approach to IDC on a periodic basis and one of the factors we would consider is a significant change in market conditions. ***Ofgem has decided to leave the scope unchanged.***

Chapter 3 Question 1: Do you agree we should set the cap on IDC for transitional projects at the bottom of the range from our advisers, ie 7.6 per cent?

All respondents commented on the use of the bottom of the range for a cap. The comments related to the evidence base used by our advisers, the signal that the choice would send and the justification for using the bottom of the range. ***Ofgem has decided to move the cap to towards the middle of the range recommended by our adviser GT*** as set out in the letter.

Chapter 4 Question 1: Do you agree with our proposed approach? If not, why?

Seven respondents commented on our approach of applying the cap on a calendar basis and reviewing it periodically. Four respondents supported the approach. One noted it enabled adjustment to reflect market conditions. Another indicated the disparity in timing of cumulative cash flows on projects in the same tender round demonstrated the need for a calendar based approach.

Two respondents favoured the use of project specific caps to reflect project specific circumstances and that finance is provided on a discontinuous basis from various loans by its corporate group and/or external funders.

However such an approach would lead to cash flows from different developers receiving different rates of interest on cash flows occurring at the same time. No sufficient evidence has been provided by developers to indicate why their project has greater risk than another developer's projects. We consider in general that all developers constructing offshore transmission assets over a similar time frame will be exposed to similar risks and there is no evidence to support different rates being applied to different projects. ***Ofgem has decided to leave the approach unchanged.***

Chapter 4 Question 2: Are there any other alternatives we have not considered? If yes, please set out the details.

All respondents provided alternative methods on one or more aspects of our approach or the methodology used. Four respondents considered the rate should be at the level required by the developer. This approach would result in Ofgem allowing differential returns between developers. As noted above we do not consider that there is evidence to support this view as the activity and associated risks are broadly comparable.

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Four respondents believed a more forward looking cap and/or annual review would be beneficial. Three cited the need to reflect prevailing market conditions. One thought the review and setting should occur within a set period each year. Another suggested that an ex post review should occur to ensure that any excess could be returned to consumers. ***Ofgem remain committed to periodic review.*** We acknowledge the views provided and will consider these further in future reviews.

Chapter 4 Question 3: Do you agree to the proposed date of implementing our minded-to changes set out in this consultation document?

Four respondents commented on the proposed implementation date. They felt the cap should not be implemented until the concerns they had raised had been answered. Another thought the cap should not be applied retrospectively.

Ofgem has already indicated its minded to approach to apply the new cap prospectively. ***Ofgem will apply a new cap from 1 December 2011.***

Chapter 5 Question 1: Do you agree with the minded-to view expressed?
Question 2: Please can you indicate any alternative views you hold and the reasons for these?

All respondents commented on our minded-to view expressed. The consumer representative respondent was firmly supportive of our view but asked that we considered the possibility of reducing the rate further. They cited:

- the need for technology neutrality;
- that for TR1 the bottom of the range requested by developers was at 2 per cent well below the proposed cap. However the bottom of the range recommended by our advisers was significantly above this and the cap is applied to current expenditure; and
- that the required return on offshore projects should fall as the technology matures.

Three energy companies expressed reservations with the minded-to view expressed in its current form. They were broadly in favour of a calendar based approach and the methodology used to compute the cap. Their primary concerns lay with the evidence base used by GT to arrive at the efficient range and Ofgem's minded-to position of adopting the bottom of the range. In most cases they sought a cap at or above recent onshore regulatory price control settlement.

Four respondents, who are either integrated energy companies or have a strong interest in development, expressed strong concerns with our minded-to view. In general, they primarily sought for a project specific IDC cap to be used. They felt this would better reflect the time the funding was obtained (financial market conditions) and the risk profile of all projects.

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