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Emmanouela Angelidaki, Phil Cope
European Electricity Transmission
Ofgem
9 Millbank
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3 May 2013

By email

Dear Emmanouela, Phil

Re: Cap and floor regime for regulated electricity interconnector investment for application to project NEMO (28/13)

Thank you for the opportunity to respond to your consultation. Centrica is responding primarily in its capacity as a major offshore wind developer in GB. Our comments relate to your proposals on Interest during Construction (IDC) for project NEMO and the interaction with IDC for offshore electricity transmission.

Your proposed regime for project NEMO's construction phase borrows from the Generator Build regime for offshore electricity transmission (the OFTO regime), i.e. you are proposing to determine the Regulatory Asset Value (RAV) of the NEMO interconnector via an *ex post* cost assessment. As with the OFTO regime, IDC on NEMO's efficient construction phase expenditure will be included in its RAV. A cap on the rate of IDC NEMO can claim will be set by Ofgem.

We understand your preferred approach to capping NEMO's IDC is to take the IDC cap from the OFTO regime as a baseline and make adjustments (up or down) to the extent that NEMO's construction phase risks differ from offshore transmission[1]. In order for your proposed approach to be successful, it is essential that the following two conditions are met:

1. A correct (i.e. risk reflective) IDC baseline must apply to the OFTO regime in the first instance.

2. A correct comparative assessment of the relative construction phase risks faced by NEMO and Generator Build offshore transmission developers must be undertaken.

[1] p33-34, para 3.46-3.50 of your consultation

Centrica do not believe that condition 1, a risk reflective IDC baseline in the OFTO regime, is being met by your current cap of 8.5% pre-tax nominal. It is our firm view that the 8.5% cap needs to be raised significantly before it can be considered reflective of offshore transmission construction risk under your *ex post* cost assessment regime.

Failure by Ofgem to increase the OFTO regime's IDC cap to a risk reflective level is undesirable *per se,* as it will discourage investment in GB offshore wind and jeopardise our 2020 renewable energy target. However, it may also jeopardise the economics of project NEMO. As the relative risks of constructing NEMO and offshore transmission are similar (condition 2), Ofgem will presumably be obliged to cap NEMO's IDC at whatever level prevails under the OFTO regime. The result may be that investment in GB interconnectors is deterred in a similar way to offshore wind.

Problems with the current approach to IDC under the OFTO regime

The OFTO regime's IDC cap of 8.5% pre-tax nominal is based on a Capital Asset Pricing Model (CAPM) that largely considers (lower risk) integrated energy companies as the relevant comparators[2]. The comparator companies used in the CAPM have diverse and substantially built asset bases, which have little relevance to the higher, more concentrated risks faced by discrete offshore transmission projects in the development and construction phase. Accordingly, 8.5% pre-tax nominal, perhaps a reasonable figure for integrated energy companies in totality, significantly under-rewards construction of offshore transmission.

It is clear from GB and German experience that developers are exposed to major risks in the course of offshore transmission construction. Consent restrictions, bad weather delays and subsea conditions all serve to make the construction phase of these projects highly challenging. The unprecedented scale, distance from shore and deeper water associated with many GB Round 3 sites will further augment the significant risks already there.

Quantifying the right level of IDC for NEMO – and offshore transmission

We note the recommendation of your consultant, CEPA, that 11.68% pre-tax nominal reflects the (UK) construction phase risks of NEMO[3]. The corollary must be that 8.5% is too low for construction of offshore transmission, given the *ex post* cost assessment applies in both cases and the construction risks are similar. We agree with CEPA that the inclusion of a ~20% Risk of Unrewarded Costs (RoUC) term is a key part of a robust NEMO IDC calculation – a RoUC term ought to apply to the OFTO regime for similar reasons. We are surprised by your commentary on page 34 and Appendix 4 of your consultation, which appears to suggest there is little or no risk of unrewarded costs arising from your *ex post* cost assessments[4]. It is surely

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[2] Grant Thornton report for Ofgem E-Serve, March 2011
[3] CEPA financeability study for Ofgem, February 2013
[4] See for example p34, para 3.48 of your consultation: *"We do not agree with the need for a risk of unrewarded costs (RoUC) term which is used to cover: severe delays due to technology or unexpected events; and/or cost over-runs, as an ex-post cost review of capex is being carried out."*

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a matter of fact that offshore transmission projects have experienced unrewarded costs under the *ex post* cost assessment, i.e. the risk of unrewarded costs is demonstrable. To cite a prominent independent example, the National Audit Office reported that Ofgem disallowed £22m of expenditure from the first four OFTOs – 8% of the developers' combined expenditure. Needless to say, the precedent of disallowed costs has continued for more recent projects[5].

We understand that Ofgem is now minded to review the IDC cap applying to the OFTO regime as part of its process for setting an IDC cap for NEMO. We strongly welcome a review of IDC under the OFTO regime for the reasons set out in this letter and look forward to engaging further with you to facilitate the establishment of a risk reflective IDC going forward.

Please feel free to contact me if you would like to discuss our response further.

Yours sincerely,

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[5] See for example Ofgem's *ex post* cost assessment report for Walney 2.

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