

Regulation and Policy

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Offshore Electricity Transmission: Consultation on proposed interest during construction approach for offshore transmission and project NEMO

Dear Helen,

Thank you for the opportunity to comment on your consultation on proposed interest during construction approach for offshore transmission and project NEMO. This response is provided on behalf of RWE Npower Renewables Limited, a fully owned subsidiary of RWE Innogy GmbH.

We are extremely concerned to see your proposals for a further reduction in the level of IDC being applied to the transmission assets for offshore projects. There seems to be little justification for this further reduction in the level of IDC and the proposal appears to be destructive to the OFTO regime. We recommend that the proposals are not implemented and that consideration is made to raising the cap in line with the actual WACC incurred by generators, which we believe would be appropriate and efficient implementation of the OFTO regime.

Justification for our view:

There are considerable overall wind farm project risks associated with the cost, efficacy and interaction of the transmission assets. Generator-build is strongly favoured by developers as it offers a way to manage these risks by combining both wind farm and transmission development, design, construction and commissioning thereby reducing a potentially significant interface risk. These projects based on the entire wind farm (and transmission) thus benefit from a WACC representative of these reduced overall risks.

Ofgem's IDC cap is based on the view that OFTO build could be financed at a lower WACC due to the certainty of recovery of asset value from Ofgem's asset valuation process. Whilst in a theoretical case this is possible (noting that there have been no OFTO build projects in the UK), in reality, OFTO-build would create significant additional risks to the generator due to the impact of the transmission system efficacy, value and programme on the viability of the wind farm investment. The associated WACC of the wind farm in isolation of the transmission assets must increase to account for these risks, either resulting in non-viability of the project, or requiring increased subsidy from the consumer.

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The premise of Ofgem's intention to cap IDC below the WACC incurred by generators, on the basis that a theoretical OFTO could operate with a lower WACC is flawed. A viable project can only be sanctioned when considering the overall risks and rewards for a project, for which the transmission and wind farm investments are causally linked. It is therefore most appropriate for the funding of the whole project to be secured. Insistence of a segregation of the project and associated funding can only add cost and risk to the project and consumer, whilst the cap only acts as a penalty to the generator for minimising overall costs. The impact of this proposal could severely compromise the viability of future generator build projects. Therefore, we strongly urge Ofgem not to pursue further reduction in IDC without consideration of the wider regulatory regime.

Further, we observe that repeated introduction of progressively lower WACC caps, which although not implemented retrospectively, are still applied to projects that have already been sanctioned and financed. Such projects then incur significant costs by means of a differential between costs incurred at WACC and the lower levels of IDC allowed. This poses a significant regulatory risk to our offshore projects and has already had a significant impact on our TR2 projects in construction. This continuation along the path of segregating the financing arrangements between transmission and wind farm assets will lead to substantial increases to the cost to the customer, by creating an unnecessary and costly misalignment between these parts of the project.

We welcome the opportunity to discuss this issue with you further. Please do not hesitate to contact me if you require any further information in relation to our response.

Yours sincerely,

Jeremy Gummow
Grid Regulation Manager
RWE npower renewables

RWE npower renewables responses to individual questions

Questions

1. Is use of WACC and CAPM appropriate for calculating IDC?

We recognise the intention behind Ofgem's approach but believe that the calculated WACC should only be the starting point and that sector and project specific risks should be taken into account when setting the appropriate level of IDC. It is inappropriate to over-rule the WACC incurred by generator-build projects without considering the wider regulatory and project regime.

Using integrated utility companies and transmission companies as comparators are not fully reflective of the specific risks faced by offshore projects.

Appropriate comparator companies need to be chosen in order to set the appropriate WACC to feed into to the IDC calculation. We believe that the comparator companies selected (integrated utilities and transmission companies) for the evaluation of offshore construction costs are too narrow and without further adjustment, do not fully reflect the risks that such projects are exposed to. Although many integrated utility companies are developing offshore projects, there will be a wide ranging WACC applied to different projects across such integrated businesses and this needs to be taken into consideration when setting the WACC for offshore. We have previously provided evidence to justify the required higher level of risk for offshore projects in the context of our company's investment decisions. Transmission companies have different risk profiles to offshore projects because funding is awarded prior to the construction of transmission assets and fully underwritten by project developers. Therefore, further adjustments would need to be made to their risk profiles.

2. Is minded to approach to accounting for risk bias for offshore transmission and NEMO appropriate?

Ofgem has not made any risk adjustment for offshore projects. We do not think that this is appropriate because we believe that the upfront risks for offshore projects are higher than for interconnector projects.

3. Do you agree with minded to approach of applying the IDC cap rate for offshore and NEMO?

There seems to be little justification for the reduction in level of IDC for offshore projects. Grant Thornton has identified a range of appropriate IDC rates, so it is unclear why Ofgem has chosen a figure at the bottom of that range. For the reasons set out above, we do not believe that this range is high enough. The IDC rate was previously set at 10.8% and was then subsequently reduced to 8.5%. In the context of larger more complex projects with increasing amounts of risk, it does not seem to be a logical step to significantly reduce the level of IDC on an ongoing basis.

Ofgem's proposed approach to cap IDC below the generator causes an unprecedented cost to the generator for pursuing generator-build of offshore transmission assets. The impact of enforcing this cost to the generator is that developers must seek higher returns from the subsidy mechanism to account for these losses and associated regulatory risk. We do not believe that this process is in the best interest for cost to the consumer.