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Dear colleague

Decision on approach to Interest During Construction for offshore transmission

Overview

On 24 May 2013 we published an open letter launching a joint review of Interest During Construction (IDC) for offshore transmission and Project NEMO[1]. On 18 October 2013 we published a consultation on our minded-to positions, building on responses to the open letter and discussions from two workshops. The October consultation outlined the proposed methodology for calculating IDC and the proposed applications to each of the regimes. We have now considered the seven responses received and this letter contains the decision on the approach to IDC for offshore transmission. The decision on IDC for Project NEMO will be published separately in spring 2014.

We have considered carefully and taken into account the consultation responses. We have amended our conclusions to reflect an updated view of the costs of debt and equity, and of the gearing ratio. We have reviewed all the broad market data and remain comfortable that the figures from the end of June continue to be applicable. We have adjusted the tax rate to 21% as this will be the corporate tax rate from 1 April 2014. In terms of the manner and timing of the application of the IDC, we are confirming our minded-to proposal.

In summary, we have decided to retain a cap on the IDC rate which will:

(i) be set in the middle, rather than at the lower end, of the range indicated in our minded-to consultation, i.e. at 8.0% on a nominal pre-tax basis;

(ii) be fixed at this level up to the end of the eligible construction period of those projects that reach Final Investment Decision (FID) in the 2014/15 financial year; and

(iii) be subject to annual review, although any future revisions will not affect projects that have already reached FID in the financial year before the revision.

The October consultation

The consultation sought views on our minded-to position as summarised below:

[1] The proposed GB-Belgium interconnector

Minded-to position and questions in October 2013
Use the Weighted Average Cost of Capital (WACC) and Capital Asset Pricing Model (CAPM) to calculate IDC, with a hybrid comparator group made up of integrated utilities and transmission companies. **Question:** Is the use of WACC and CAPM appropriate for calculating IDC here?
Cap set at the bottom of the range at 7.0%, calculated using: • as the cost of debt the 2-year average for A and BBB rated bonds - iBoxx Sterling Nonfinancial - less one standard deviation • for the Risk Free Rate the 10-year average of the 10-year UK gilt – less one standard deviation • Market Risk Premium from the Credit Suisse Global Investment Returns Sourcebook 2013 • Equity Beta estimated from the hybrid comparator group assembled by Grant Thornton. **Question:** Is our minded-to approach to accounting for risk bias for offshore transmission appropriate?
One cap for all projects reaching FID in one financial year, that rate being fixed at FID and applying for the whole construction period. For projects currently accruing IDC, to apply the new cap from 1 April 2014. To review the cap annually. **Question:** Do you agree with our minded-to approach of applying the IDC cap and rate for offshore transmission?

We received seven responses to the October consultation: one from a shareholder of an offshore transmission licensee, four from generator developers and two from interconnector developers. The first five focused on offshore transmission. In the section below, we outline the views provided in these five responses, our further analysis and our final decisions in relation to our minded-to positions.

Analysis of responses

1. Calculation of the cap with CAPM

Respondents were broadly supportive of the methodology we proposed to adopt for calculating the range for IDC. The OFTO shareholder respondent suggested that using transaction data from the secondary market would be more appropriate in the future when such data is available. As explained in the Grant Thornton report[2] that accompanied the October consultation, such data is not currently available. However, as we will be conducting annual reviews of IDC, should this situation change in the future we would be in a position to revise our methodology if we consider it appropriate at that time.

Several respondents disagreed with our proposal of selecting a cap at the bottom of the range of values calculated by Grant Thornton. In their view, it does not adequately reflect market conditions, risks and financing arrangements and could therefore potentially damage or hinder investment in offshore transmission. As set out below, we have made some revisions to our methodology after analysing the responses to the consultation.

Cost of debt and the risk free rate

Two respondents commented that the mean cost of debt and the mean risk-free rate

[2] https://www.ofgem.gov.uk/ofgem-publications/83903/grantthorntonreviewofinterestduringconstructionstage2.pdf

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should be used instead of the mean less one standard deviation. They demonstrated that construction phase financing had, to date, been in the form of equity investment provided by the developer's parent group. They pointed out that refinancing was achievable once construction was complete, but it had not been achieved before or during construction.

After considering these responses we note the practical constraints on developers which seem to limit their access to highly leveraged finance and now consider that this makes the mean of the ranges rather than the bottom the appropriate values for the risk-free rate and the cost of debt.

Market risk premium

One respondent stated that we should use the value adopted in the recent RIIO T1 price control. However, the offshore transmission price control regime has many differences from that applying to onshore network operators. In particular, onshore networks are set ex-ante allowances involving the sharing of over- and under-spending, while offshore transmission sets IDC in relation to ex-post cost levels, with all efficiently incurred expenditure being remunerated. Onshore price controls are intended to cover an extended future period (currently 8 years) while offshore IDC provides returns on construction prior to a single payment at the point of asset transfer. Therefore, we remain persuaded by Grant Thornton's analysis and resulting advice to use the value of 4.4% taken from the Credit Suisse Global Investment Returns Sourcebook 2013 rather than the value used for RIIO T1.

Equity Beta

In the October consultation we stated that we thought the equity beta calculated by Grant Thornton was too high, noting that National Grid's equity beta is 0.31. Several respondents disagreed with our position, suggesting either that Grant Thornton's equity beta for offshore transmission should be retained or that a higher equity beta should be adopted as integrated utilities and transmission companies are not suitable comparators. As equity beta is a measure of correlation between the company and the market as a whole we would expect a low value for construction of transmission assets remunerated by guaranteed revenue. We do not believe that a value above 1, indicating greater variability than the market as a whole, is appropriate. We would certainly expect a lower value than the equity beta observed for developer companies, the generality of whose revenues are exposed to market forces and not guaranteed. For this review we maintain Grant Thornton's recommended number of 0.88, though further investigation is a particular priority for the next review.

Gearing

Respondents commented that finance for offshore wind developments has been in the form of 100% equity investment during the construction phase. However, this has not been direct investment of external equity but the provision of finance from the balance sheets of the parent company or companies, in the form of equity. We will reflect this by making use of the gearing of the Integrated Energy Utility (IEUs) group rather than the hybrid comparator group including transmission companies as well as IEUs. We will however retain the use of the hybrid group for another parameter, the equity beta. This is because we can distinguish between the beta value, where we are seeking to represent the reward to regulated revenue entities, and the gearing pertinent to the construction phase, where construction is being funded by a particular class of company. By adopting such an approach we are distinguishing between the nature of the developers on the one hand and that of the asset being developed (attracting regulated revenue) on the other.

2. Assessment of asymmetric risks

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All respondents argued that uplifts compensating for risk at the construction phase, the development phase or both should be included when calculating the range for IDC for offshore transmission. Reasons cited were increasing technology risk with Round 3 projects and the risk of Ofgem disallowing costs deemed not to be economic or efficient.

The risk of disallowed costs

Ofgem does not accept that the disallowance of uneconomically or inefficiently incurred costs creates asymmetric risk that should be rewarded. Ofgem has set out clear cost assessment principles in the guidance and published cost assessment reports for all offshore transmission projects, setting out rationale for any disallowances and making our cost assessment process transparent. The October consultation explained that, to reward inefficient costs would reduce the effectiveness of cost assessments and disallowances that aim to encourage economic and efficient behaviour. We therefore do not accept the argument that disallowance of inefficient costs raises any legitimate need for an increase in efficient financing costs reimbursed through IDC.

Development risk

We noted that for generator build offshore transmission, the uncertainty in the project lies with the build of generation capacity, while the transmission link is a necessary consequence of the decision to establish generation. In a regime where the economic and efficient development costs are reimbursed to the developer these activities incur the same level of risk as subsequent construction and there is no rationale for an additional allowance for development risk.

Construction risk

The ex-post nature of the cost assessment means that any unexpected, but efficient, cost overruns are accepted in the final asset value. This substantially reduces the risks faced by the developer during construction, in comparison to risks faced by the comparator companies during construction and operation phases. As such we do not consider an additional factor for construction to be appropriate.

3. Application of the cap

Cap on IDC

One respondent commented positively on our proposal to continue our policy of applying a cap for IDC rather than a fixed rate. No other respondents commented on this aspect. We confirm that we will continue to apply a cap rather than a fixed rate to the IDC for offshore transmission.

IDC fixed at FID for duration of project

The majority of respondents agreed with our proposal to fix IDC at FID for the duration of the project, although one respondent felt that IDC should be capped at different rates for the development and construction phases because of differing levels of risk. In the October consultation we explained that we do not accept the argument that levels of risk in offshore transmission projects differ between the development and construction phases. We are therefore confirming our minded-to position, that IDC will be fixed at FID until construction of the project is complete.

A cap on IDC for all projects reaching FID in the same financial year

Respondents were supportive of our minded-to approach, to have one cap on IDC for all projects reaching FID in the same financial year, although one argued that project-specific rates of IDC would be more appropriate. Adopting a single cap on IDC for all projects

instead of project-specific caps is more practical to implement, and still reflects the market conditions around the time of FID. A cap instead of a fixed rate still results in a degree of project-specificity and flexibility, if developers choose a rate below the cap. A cap means that any savings made from developers accessing capital at a lower rate during the construction period can be passed on to consumers. We have therefore decided to confirm our minded-to position of one cap on IDC applying to all projects reaching FID within the same financial year.

Review

One respondent suggested that an annual review of IDC might be too much work and that a review every two years would be more appropriate. We were not convinced by this argument and believe that an annual review of the cap would ensure that it remains flexible and responsive to market movements, which were criteria identified in response to the May open letter. Changes resulting from such reviews will not affect the projects that have already reached FID. The decision to make a change to the cap will be communicated around three months prior to the change coming into force, following consultation where appropriate, to give developers time to factor this number into their FID.

Projects currently accumulating IDC

One respondent argued that the new cap for IDC should not be applied to projects that are already receiving IDC. In the October consultation, we stated that the new cap on IDC will be applied to all expenditure incurred from April 2014 on projects currently receiving IDC. This was the position set out in the October 2011 decision letter on IDC and in the cost assessment guidance. It is therefore what developers understood to be the case when making their financial arrangements. Our final decision is that the new cap on IDC (8.0%) will apply to all expenditure incurred from 1 April 2014 on projects currently accumulating IDC.

Our decision

Following our analysis of the five responses relevant to offshore transmission, we have decided to set the new rate of IDC for offshore transmission at **8.0%**. This rate will apply to all projects that reach FID from **1 April 2014**. It will also apply to expenditure incurred from 1 April 2014 on projects currently accumulating IDC that reached FID prior to this date.

Yours sincerely,

Min Zhu
Associate Director, Offshore Transmission

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Appendix – Summary of Responses to October consultation

Question	**Response**
2.1 Is the use of WACC and CAPM appropriate for calculating IDC here?	All respondents agreed that the use of CAPM and WACC are appropriate but some highlighted the importance of inputting appropriate parameters. The majority of respondents had concerns over some of the existing parameters, such as the cost of debt or the risk-free rate.
2.2 Is our minded-to approach to accounting for risk bias for offshore transmission and NEMO appropriate?	All respondents felt that the risk associated with offshore transmission had been underestimated. Some argued that uplifts for construction and/or development risk should be included.
3.1 Do you agree with our minded-to approach of applying the IDC rate for offshore transmission and NEMO?	Respondents were generally supportive of our proposals. All respondents agreed that IDC should be fixed at FID. Three respondents commented on different aspects of application: one suggested that a review every two years would be more appropriate than an annual review; one suggested that project-specific rates of IDC should be introduced and another suggested having a different cap on IDC for the development and construction phases. One respondent disagreed with our policy of adjusting the cap on IDC for projects that are currently accruing IDC.

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