

Helen Curry
Ofgem
9 Millbank
London
SW1P 3GE

12th November 2013

Dear Helen,

Consultation – Interest During Construction

Transmission Investment is responding to this open letter primarily in its capacity as a developer of interconnector projects.

We welcome this opportunity to comment further on Ofgem's IDC proposals for interconnectors (i.e. NEMO), and to build on the comments provided by our previous letter of 2nd May and 19th June 2013.

However, we continue to be disappointed that Ofgem is not allowing other projects to be progressed under a cap and floor regime at this time. This is not in Great Britain's interest for the following reasons, and we urge Ofgem to accelerate opening up the regulatory regime for interconnectors to other projects immediately:

- i) it appears to us to be discriminatory to single out one project for special treatment;
- ii) the lack of a regulatory regime is increasing the risk and therefore cost of developing interconnector projects;
- iii) there is a duty under EU law to facilitate the progress of Projects of Common Interest (for which there are several GB interconnector projects);
- iv) there are strong GB reasons in terms of security of supply and access to affordable energy that are being hindered by this lack of regulatory progress.

Nevertheless we provide our responses to your specific questions below.

Question 1: Is the use of WACC and CAPM appropriate for calculating IDC here?

While we note that the use of WACC and CAPM is the normal approach used by regulators to calculate allowed rates of return, we continue to have concerns that listed comparator companies may not be suitable as they are invariably in different sectors (e.g. integrated utilities, or oil & gas).

We therefore continue to suggest that the historic returns of similar projects, as demonstrated by the ratio between invested capital and asset sale prices following successful completion of the development or construction stages of a project, be used as an additional reference point¹.

¹ We are not aware of any examples of this for UK interconnectors, but there are several examples for offshore wind. Interconnector examples do exist outside the UK (eg Basslink).

Question 2: Is our minded-to approach to accounting for risk bias for offshore transmission and NEMO appropriate?

We note the approach taken to accounting for interconnector development risk, which essentially involves calculating a reasonable premium for successful interconnector developers and then allowing them to recover this through an enhanced rate of IDC. We still believe that this is the best approach, as set out in our responses of 2nd May and 19th June 2013 to the earlier NEMO consultation as it provides certainty to developers and the right incentives in respect of minimising development expense and development time periods.

We do however have reservations with respect to some of the application of this approach:

- i) In the UK interconnector projects have not been developed as part of a wider portfolio of interconnector projects. The development risk on only one (partially) successful project developed since privatisation has not been underwritten by foreign consumers. As such applying an approach based on average returns across a portfolio would seem to underestimate the risk and therefore the development return required.
- ii) Applying benchmarks based on the oil & gas industry does not seem appropriate as there seems to be no particular reason why the risks faced by oil exploration companies should provide any sort of guide to the risks faced by interconnector developers. The key risk for interconnectors is, as stated above, the absence of any suitable regulatory model. For non NEMO projects there is currently no regulatory framework other than the pure merchant model, for which clearly this IDC calculation is not relevant. Therefore, any developer committing development expenditure in the current environment is taking not only the normal project development risks but very significant regulatory risks as well².
- iii) Furthermore we do not consider that the development-premium part of the IDC rate has been calculated correctly as it seems to ignore the fact that the returns on the successful projects need to be multiples of a developer's average return as they need to compensate for the capital written off and returns not earned in unsuccessful projects – see Annex 1. As such we would consider that the premium to be applied probably needs to be very significantly higher than (in fact multiples of) the 0.5% proposed.

Question 3: Do you agree with our minded-to approach of applying the IDC cap and rate for offshore transmission and NEMO?

As we noted in our previous consultation response, we have a preference for setting the IDC for a project as soon as possible rather than waiting until a project reaches FID. This would allow the project's developers to approach investors and raise finance based on a firm business plan.

We hope that you find this letter a useful explanation of our views. If you have any questions please do not hesitate to contact me.

Yours sincerely



Sean Kelly
Partner

² For NEMO a regulatory model is being put in place which may be satisfactory to the developers, but no model existed for the bulk of the project's development

Annex 1 – Calculations of required returns on successful projects

It appears that the oil & gas development risk premium provided by the Grant Thornton method will be based on the average return over a large *portfolio* of exploration campaigns. Most of these campaigns will be unsuccessful, which would imply that the small number of successful campaigns will need to provide a much higher return.

For example if an oil exploration company drills ten exploration wells a year, each costing £10m, and if they need to earn a 14.2% return³ on this £100m investment then they will need to have earned £114.2m on this portfolio of prospects by the end of the year. However if on average only half of these wells actually strike oil then the average value of the each five oilfields discovered each year will need to be £22.8m (i.e. £114.2m divided by five). For each well that is a return of 128% on the £10m invested *in that particular well*.

This suggests that the development risk premium provided to a successful interconnector project should be higher than that calculated by Grant Thornton. (By definition in the case of an interconnector IDC calculation the project in question will always be “successful”, as the calculation is only relevant for projects that have successfully reached FID).

If a hypothetical interconnector project developer would need a 14.2% pa return (analogous to oil exploration), and if the effective duration of the development investment is three years⁴, then £100 invested in three projects will need to increase to £149 three years later ($£100 \times 1.142 \times 1.142 \times 1.142$). If the developer splits the £100 between (say) three projects (£33.33 each) and only one is successful then the successful project will have to convert a £33 investment into a £149 return in three years, an annual return of 65%.

Over the past 20 years the success rate of British⁵ interconnector developments has been poor: two projects were fully developed to the extent required for FID (BritNed and NSI), but only one of these went ahead. We are also aware of several other projects that received significant development expenditure before being abandoned by their sponsors, and the development of BritNed cannot be described as fully successful as it was subjected to an EU profit cap which was not anticipated until near the end of the development process. Given the small sample size of successful projects, it is not possible to quantify with any degree of accuracy the GB interconnector a success rate⁶.

³ As calculated by Grant Thornton, and a 5% premium to the oil and gas industry in general.

⁴ Development durations are typically longer than this, we development funds being invested over this extended period. This value represents the average time from making the investment to FID.

⁵ ie excluding projects that form part of an Irish transmission grid.

⁶ In the energy sector generally it is notable that there are fully-developed projects in previously attractive sectors such as offshore wind that are struggling to proceed due to regulatory and political uncertainties.