SCOTTISHPOWER RENEWABLES

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Ofgem
9 Millbank
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Sent by email only to offshore@ofgem.gov.uk

Dear Helen,

Proposed Interest During Construction Approach for Offshore Transmission and Project NEMO

Thank you for the opportunity to respond to the above consultation of 18 October 2013. I am pleased to submit this response on behalf of ScottishPower Renewables (SPR).

SPR is the UK's leading developer and operator of wind generation projects involved in almost 9GW of offshore wind projects in the UK. These include the 7.2GW East Anglia and 1.8GW Argyll Array projects in development. In addition we are currently constructing our transitional West of Duddon Sands (WoDS) project, which is due to enter into commercial operation by 2014. Therefore we have a critical interest in ensuring that the offshore transmission arrangements are not only transparent and fair, but are also robust, realistic and reasonable in the market and circumstances in which we operate.

We have listed below our responses to your questions and we hope you find them clear and helpful.

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

We believe retaining CAPM is a positive and logical choice as it is understood and offers a market based risk premium that can be used for a single project.

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

Ofgem provides a worked example in Table 1 to illustrate its 'minded to' methodology for offshore transmission which results in a WACC (pre-tax nominal) in the range 7.00% to 8.87% (based on June 2013 market data). Ofgem also suggests that it is minded to use the lower end of the range (updated to reflect prevailing input parameter values) to set the nominal pre-tax cap for IDC[1]. Ofgem's reason for using the lower

[1] Condoc executive summary, page 6

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end of the range appears to be related to its assessment that certain aspects of the methodology may lead to an inappropriately high value of WACC.

We do not believe that Ofgem's assessment fully reflects the characteristics of the generator build offshore transmission market, and as a result, we think the indicative cap derived by this approach may not adequately reflect the risks, market conditions or financing arrangements faced by generator build offshore transmission developers. This is for the following reasons:

- Equity beta: Ofgem says that although it is minded to continue using the comparator group of companies defined by Grant Thornton to estimate beta, it considers that the resulting equity beta (0.88) may be inappropriately high - particularly when compared with National Grid's equity beta of 0.31[2]. We do not believe that National Grid is a valid comparator as it is not representative of the entities currently undertaking generator build projects (i.e. integrated utilities or dedicated renewable generation developers). Such companies are exposed to different risk conditions to those of NGET facing competing demands on scarce capital resources, for example, energy networks, thermal generation and/or onshore renewable generation. We therefore disagree that the Grant Thornton approach results in an inappropriately high value.

- Gearing: Ofgem says that although it is minded to continue assuming maximum debt funding of 40% for offshore development, it considers this level of debt funding is particularly conservative, given that project finance should be available at over 80% borrowing, and that this may result in an inappropriately high WACC[3]. We think it is unlikely that project finance will be available for a generator build development. Further, if it is available it is unlikely to be non-recourse debt (and so will be relying on the developer's balance sheet); the risk of non-recovery means it will not be at A or BBB rating and the nature of the OFTO transaction process means the transaction completion timing risk will be an issue to be addressed. We therefore disagree that this approach results in an inappropriately high WACC.

- Risk of disallowed costs: Although generator build developers can take some comfort from the cost assessment approach being adopted by Ofgem, we believe that there is still a risk of generator build developers being unable to recover disallowed costs. Relatively few cost assessments have been undertaken to date from which generator build developers can take certainty on the level of post-event cost recovery they will realise. Although the number of cost assessments should continue to increase, we believe there is an increasing risk that developers may be obliged to take decisions that would expose them to the risk of disallowed costs. For example, the supply chain is still very limited and the proposed approach to CfD pricing will force generators to contract as early as possible - and earlier than would otherwise be prudent given market conditions (relating to commodity prices for example).

- Technology risks: Ofgem says it considers that technology risks are higher for interconnectors/NEMO than for offshore transmission development, and has reflected this in the respective approaches to IDC. However, we believe that the evolving nature and scale of offshore developments will require a significant shift in

[2] Condoc para 2.21
[3] Condoc para 2.19

offshore technology and approaches, with generator build developers being exposed to the associated risk arising from this.

As a result of these considerations, we consider that the indicative cap of 7.00% derived by taking the lower bound of the minded-to approach (based on June 2013 market data) does not adequately reflect the risks, market conditions or financing arrangements faced by generator build offshore transmission developers. We believe the approach for offshore transmission should be further refined to help encourage and support the significant levels of investment that will be required to help achieve the Government's energy policy objectives.

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

Provided Ofgem continues to consider the changes in the evolving OFTO asset market, technologies and financial market and investor conditions, and reflect the lessons learned from this in timely and meaningful consultations on the annual IDC cap proposals, the minded-to approach to applying the IDC cap and rate is a positive step forward. The minded-to approach should provide some certainty in this respect for generator developers forecasting the financial performance of projects and for finance planning purposes.

We would welcome the opportunity to discuss our responses more fully with you and if you would like to do so, or if you require any further information from us, please contact me on 0141 614 3101 or at Lindsay.McQuade@scottishpower.com

Yours sincerely,

Lindsay McQuade
Policy & Innovation Director
ScottishPower Renewables