

Offshore wind farm developers
and other interested parties

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Dear colleague

Interest During Construction for Offshore Transmission applying in the financial year 2015/16

1. Decision on the rate of the IDC cap

For offshore transmission assets built by offshore generators, Ofgem determines the efficient cost of capital for construction of those assets by allowing for the application of Interest During Construction (IDC). The value determined by Ofgem serves as a cap on the rate of the cost of capital. The actual cost of capital is reviewed for each project and the rate applied to that project is the lower of the cap or the rate submitted by the developer of that project (subject to economic and efficient justification). In December 2013, we determined¹ the IDC cap rate applicable from 1 April 2014 to be 8.00%². We also committed to annual reviews of to reflect current market conditions.

With the assistance of Deloitte and CEPA, our financial advisors for Tender Round 3, we have reviewed our IDC calculation to establish the value to apply during financial year 2015/16. We have used the same methodology as was used last year but updated all input parameters with current data. Although all these input parameters vary somewhat from last year's numbers these changes cancel out each other's effects in large measure. The overall result is sufficiently close to the 2014/15 outcome as to merit no change from the previous value. The detailed calculation with breakdown of parameters, together with a chart showing the impact of the movement of each parameter, is provided in the Annex to this letter.

We therefore determine that the IDC cap rate for 2015/16 remains unchanged at 8.00%¹.

2. Application of the IDC cap

We have reviewed how we apply the cap in 2014/15 since the previous review, and conclude that all the factors supporting this application remain valid. We therefore confirm that we will make no changes to the application of the IDC cap.

Cap on IDC

We will continue to apply a cap rather than a fixed rate to the IDC for offshore transmission.

¹ <https://www.ofgem.gov.uk/ofgem-publications/86765/decisiononapproachtoidcoffshoretransmission.pdf>

² Pre-tax nominal

IDC cap fixed at Final Investment Decision (FID) for duration of project

We will continue to use the same IDC cap fixed at FID for a project until its construction is complete.

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

We will continue to apply the same cap on IDC for all projects reaching FID in the same financial year.

3. Subsequent Review

We consider that an annual review of the cap will ensure that it remains flexible and responsive to market movements. Changes resulting from such reviews will not affect the projects that have already reached FID. Any 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. We will continue this practice.

If you have any queries in relation to IDC matters, please contact Andrew Stone on 0207 9017035 or at Andrew.stone@ofgem.gov.uk.

Yours sincerely,

Min Zhu

Associate Director, Offshore Transmission

Annex Calculation of the IDC cap for 2015/16

Table 1: Input parameters of IDC cap rate calculation for 2015/16

Component	Parameter	Value	Source
A	Cost of debt (nominal and pre-tax)	4.56%	2 year average yield on A and BBB rated bonds more than 10 years from iBoxx Sterling non-financial series
B	Risk-free rate (nominal)	3.66%	Standard deviation either side of ten year gilt ten year spot yield average
C	Market risk premium	4.60%	Credit Suisse Global Investment Returns Sourcebook
D	Equity beta	0.90	Comparator companies using 2 year average of weekly price vs the MSCI World Index
$E = B + (C \times D)$	Cost of equity (nominal, post-tax)	7.80%	
F	Gearing	33.80%	Assembled comparator companies
G	Tax rate	20.00%	HMRC
$H = A \times F + E \times (1 - F) \times 1 / (1 - G)$	Pre-tax WACC (nominal)	7.99%	

The magnitude of overall change is minimal with a 0.01% decline in the prevailing IDC rate.

Figure 1: Diagram illustrating impact of IDC input parameters from 2014/15 to 2015/16

