

Offshore wind farm developers
and other interested parties

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Date: 4 March 2016

Dear colleague

Interest During Construction for Offshore Transmission applying in the financial year 2016/17

1. Decision on the rate of the IDC cap

For offshore transmission assets built by offshore generators, Ofgem assesses and determines the final transfer value once assets are built. An efficient cost of capital for construction of those assets is applied during the relevant period 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 2013¹, we determined the IDC cap rate applicable from 1 April 2014 to be 8.00%. We also committed to annual reviews to reflect current market conditions. In December 2014², the IDC calculation was not found to be materially changed (7.99% as compared to 8.00%) and was left unchanged at 8.00% from 1 April 2015 to 31 March 2016³.

We have updated the data as per our annual review on 31 August 2015, publishing a consultation in December 2015, seeking stakeholder views on this review. We have used the same methodology as was used last year and updated all inputs. 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 received two responses to our December 2015 consultation⁴. One responder highlighted disagreement around our application of a cap for IDC. The application of a cap was consulted in 2013 and a decision made to apply a cap, with annual updates to the cap level. We have considered the reasons for this decision and consider that it continues to remain valid. One responder highlighted concerns over the application of IDC to project finance. We are comfortable that our established methodology continues to act as an effective proxy when setting a cap on interest during construction but will continue to keep this under review. All input has been noted by Ofgem and we thank responders for taking the time to respond to this consultation.

We determine that the IDC cap rate for 2016/17 is 7.44%.

¹ https://www.ofgem.gov.uk/sites/default/files/docs/decisions/decision_letter_idc_0.pdf

² https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/20141107_draft_decision_letter_idc_as_20141202_2.pdf

³ https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/20141107_draft_decision_letter_idc_as_20141202_2.pdf

⁴ https://www.ofgem.gov.uk/sites/default/files/docs/minded-to_letter_idc_20151209_final.pdf

2. 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.⁵

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

The IDC cap fixed at FID for a project is in place until its construction is complete.

Applicable FID year	IDC cap
1 April 2014 – 31 March 2015	8.00%
1 April 2015 – 31 March 2016	8.00%
1 April 2016 – 31 March 2017	7.44%

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 prior to the change coming into force, following consultation where appropriate, to give developers time to factor this number into their FID.

If you have any queries in relation to IDC matters, please contact Scott Laczay on 0207 901 7468 or at Scott.Laczay@ofgem.gov.uk.

Yours sincerely,



Steve Beel

Partner, Competitive Networks

⁵ https://www.ofgem.gov.uk/sites/default/files/docs/decisions/decision_letter_idc_0.pdf

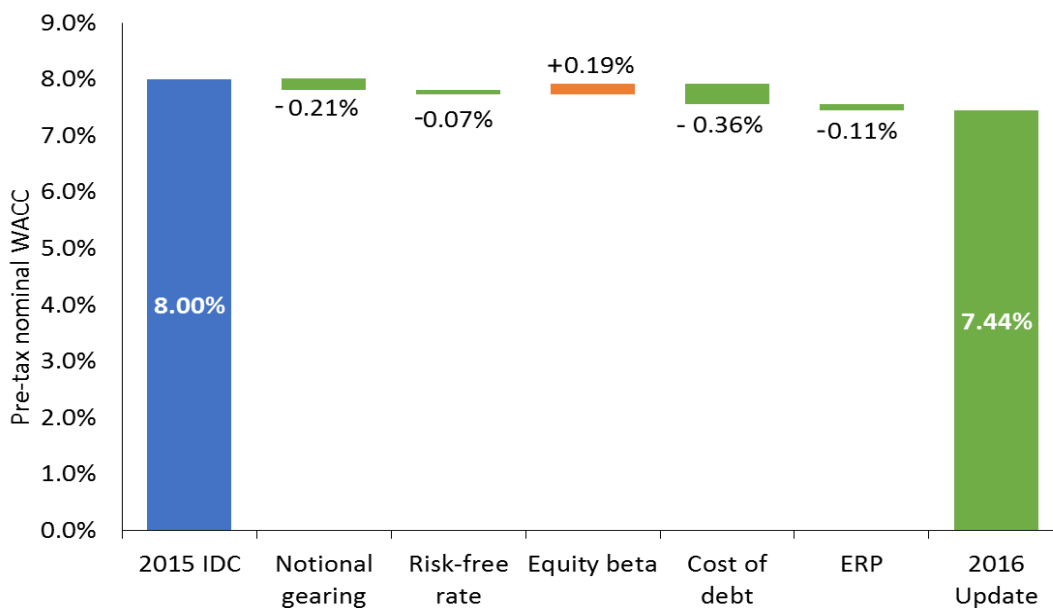
Annex Calculation of the IDC cap for 2016/17

Table 1: Input parameters of IDC cap rate calculation for 2016/17 as compared to 2015/16 IDC cap calculation

Component	Parameter	2015-16	2016-17	Source
A	Cost of debt (nominal and pre-tax)	4.56%	4.29%	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%	3.41%	Ten year average of ten year gilt spot yield
C	Market risk premium	4.60%	4.50%	Credit Suisse Global Investment Returns Sourcebook
D	Equity beta	0.90	0.92	Comparator companies using 2 year average of weekly price vs the MSCI World Index
E = B + (C X D)	Cost of equity (nominal, post-tax)	7.80%	7.55%	
F	Gearing	33.80%	38.70%	Comparator companies
G	Tax rate	20.00%	20.00%	HMRC
H = A x F + E x (1 - F) x 1 / (1 - G)	Pre-tax WACC (nominal)	7.99% *	7.44%	

* IDC cap for 2015-16 remained 8.00% as the recalculation of 7.99% was deemed immaterial. The decision was published in December 2014⁶.

Figure 1: Diagram illustrating impact of IDC input parameters from 2015/16 to 2016/17



⁶https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/20141107_draft_decision_letter_idc_as_20141202_2.pdf