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For the attention of:

Okon Enyenihi
Electricity Transmission
Ofgem
9 Millbank
London, SW1P 3GE

27th January 2017

Dear Okon,

Response to "Statutory Consultation on Proposed Interest During Construction for Offshore Transmission and proposal to extend annual methodology to Interconnectors granted the Cap and Floor Regime"

National Grid Interconnector Holdings Limited (NGIHL) welcomes the opportunity to respond to this consultation on what is a technically complex issue. This response is not confidential and we would be happy for it to be published on Ofgem's website.

NGIHL is responsible for existing electricity interconnectors owned by National Grid plc and the development of new interconnection projects. National Grid's interconnector interests include:

- The British parts of the England France Interconnector (IFA), North Sea Link (NSL), IFA2 and Viking interconnector projects; and
- A 50% share of the BritNed link jointly owned with Tennet in the Netherlands and a 50% share of the Nemo link jointly owned with Elia in Belgium.

The detailed approach to calculating Interest During Construction (IDC) has a major bearing on the attractiveness of interconnector projects and a careful balance has to be struck to ensure that there remains an incentive to invest whilst protecting the interests of end consumers. Our response is made with this balance in mind.

We continue to believe that, given the impacts of both cap and floor, it is important that the project RAV should fully reflect the efficient capital cost of establishing the interconnector capacity, including the financing costs during construction. If this were not the case, then there would be systematic ex-ante bias against interconnection investments despite their important net social welfare benefits. We are pleased that Ofgem continues to recognise and distinguish between the different risk aspects of interconnectors and offshore transmission projects.

NGIHL continues to support the use of CAPM as the methodology for assessing the returns required by investors and we appreciate the potential transparency that this approach brings to determining proposed IDC values. In addition we note that the financial parameters for FiD approved cap and floor regulated interconnectors have to date been on a project specific basis and welcome the intent to move to a more consistent and transparent approach for future projects.

Generally we are supportive of the removal of any subjectivity in the calculation, but we are not convinced by the proposal to apply the same principles for interconnectors that are used for OFTOs. We believe that these are two very different types of project in terms of cost, risk, technology etc., and that separate principles should be maintained for interconnectors. Please see the attached appendix for detailed comments on certain aspects of the proposed approach.

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As stated above, the calculation of IDC is technically complex, but fundamental to the financing of future interconnector projects, so it is essential that the right decisions are made so as to continue to encourage investment in interconnectors whilst protecting the interests of end consumers. With this in mind, we would welcome the opportunity for our respective experts to meet and discuss the detail of these proposals bilaterally.

If you have any questions on any aspect of this response, or would like to organise such a meeting, please contact John Greasley on 07836 357137 or at John.Greasley@nationalgrid.com

Yours Sincerely

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Appendix IDC Review: NGIHL detailed comments

a) We would prefer that interconnector IDC rates be considered as part of the end-to-end interconnector cap and floor regime rather than alongside OFTOs. This would have the potential advantages of:

- Focussing more directly on the interconnector policy in the context of agreed cap and floor principles as part of an overall end-to-end process;
- More specifically recognising the difference between the OFTO and interconnector regimes e.g. interconnectors being design, build and operate compared with (to date) the shorter-term OFTO construction followed by sale as part of a broader wind farm development; and
- Allowing more timely and specific project determinations (at FiD) reflecting interconnectors' higher individual project value and lower approval frequency than OFTO projects.

b) The consultation mentions the application of a cap rather than a fixed rate for interconnectors (section 4, page 4). A move to a capped rate would be a significant policy change which has not been discussed previously and NGIHL would welcome confirmation that this is not the policy intent.

c) The March 2013 consultation and FiD approved cap and floor projects to date have differentiated between OFTO and interconnector equity Beta values through the use of different comparator groups (integrated energy utilities for interconnectors). The interconnector comparator group and associated equity Beta values appear to have changed without consultation. We continue to believe that that the integrated energy utilities group is a more appropriate comparator for interconnectors.

Additionally, previously differentiated interconnector/OFTO policy decisions which appear to have become aligned are as follows:

- Interconnector cap and floor IDC debt has so far been based on a 20-day measured debt rate rather than the OFTO 2-year measurement period
- Para 2.2 of the October 2013 consultation (the last policy discussion we can locate on this specific subject) states that the cost of debt will be determined from BBB rated bonds as opposed to a combination of BBB and A rated bonds

For both of these areas the previously stated policy is preferable to NGIHL

d) The exact source and policy intent behind the choice of Equity Risk Premium (ERP) value (e.g. the worldwide, arithmetic premium relative to bonds) is not sufficiently clear to comment upon. We would note however the material range of values available and would appreciate clarification over why, for example, the worldwide premium relative to bonds has been chosen in preference to the UK premium relative to bills when seeking to add a value to a risk free rate within a UK regulatory context.

e) More fundamentally, there is evidence that Total Equity Market Return (TMR) is more stable over time than its components, the risk free rate (RFR) and equity risk premium (ERP). Consequently and as previously recognised by Ofgem and others, in applying CAPM it is more reliable to calculate ERP from TMR and RFR, rather than to use values of ERP and RFR that are derived from different data sources or covering different timescales.

It would be preferable for the value of ERP that is used for these IDC calculations to be obtained by subtracting the chosen estimate of RFR from the more stable value of TMR (around 6.5% for World Index in the Credit Suisse Global Investment Returns Sourcebook 2016) which would be consistent with the cap and floor cap cost of equity calculation and address our view that the real total market return of around 5% implied by the values of RFR and ERP in Table 1 of the consultation (c.0.5% and 4.40% respectively) are anomalously low. As with point d) above we would welcome clarification as to why a World index has been used rather than a UK only equivalent.

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f) We think it would also be good methodological practice to deflate the cost of debt and risk free rate components of the calculation by an appropriate inflation index specific to the period of the underlying dataset rather than apply a global forward looking inflation index (Government Liability curve) to historic data.