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Via email

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Dear Kate,

Interest During Construction Review

National Grid Ventures (NGV) welcomes the opportunity to engage with Ofgem on proposed changes to the methodology for calculating interest during construction (IDC) for Offshore Transmission and future interconnector projects.

NGV is a ring-fenced division of National Grid plc, responsible for developing and operating businesses in competitive energy markets across our UK and US territories. NGV's portfolio includes:

- Joint stakes in all the UK's existing electricity interconnectors to continental Europe — 3GW of capacity that provides consumer benefits by bolstering security of supply, facilitating the integration of renewables and enabling access to competitive supply;
- A pipeline of further interconnectors to Europe — including 3.4GW currently under construction and our Viking project which is in the later stages of development.

The changes to IDC are only relevant for Window 2 and later projects and so have no impact upon NGV's NSL, IFA2 and Viking projects. However, NGV considers that implementing an enduring, transparent regime is essential to overall success. Based on our experience and insight, NGV has some specific comments on the proposed changes to the IDC methodology.

Over the last few years, the cap and floor (C&F) regime has helped to deliver much-needed investment in interconnection for the UK. It is always sensible for any regime to evolve as it matures. However, NGV believes that the regime is still relatively immature; multiple projects are under development and construction, but none yet operational. For complex projects that can take over ten years to develop and construct, a long-term vision is required such that investors have visibility and certainty over key elements of the regime. As such, Ofgem should retain as much consistency of policy as possible across C&F windows unless there are good reasons to change, this approach would align to one of Ofgem's core principles for C&F[1].

NGV's responses to the questions raised in the consultation are in Appendix 1. Fundamentally, NGV's points are that there should be stability in policy between cap and floor windows especially with regard to the 'Additional Uplift'. Where there are changes, these should not be retroactive, and must be clearly considered and justified. Additionally, comparison between interconnectors and OFTOs must be done in a way that is appropriate and recognises the regimes fundamental differences.

NGV would be glad to discuss the views contained within this letter, should that be helpful. For further details, please contact Jonny Gallagher (jonny.gallagher@nationalgrid.com).

Kind regards,

Terry McCormick
Head of Markets and Regulation
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[1] "*The regime will be designed to ensure unbiased and non-discriminatory treatment between existing interconnector owners and future developers, so that there is no advantage for certain developers*" See Page 14, https://www.ofgem.gov.uk/sites/default/files/docs/2011/06/cap-and-floor-regime-for-regulation-of-new-subsea-interconnector-investment5.pdf

Appendix 1

1. ***Do you agree with aligning our approaches to the setting of IDC to ensure consistent application across these network assets?***

NGV agrees that a level of alignment is appropriate. However, this must still ensure that the differences between asset classes are adequately reflected, it must not enforce uniformity. The consultation draws parallels between the OFTO and interconnector regimes. There are similarities, but also important differences, particularly around IDC.

In principle, IDC should reflect the risks and cost of capital for the project developer until revenue is generated or asset transfer takes place. In the OFTO sector, IDC affects the transfer value paid by the OFTO. The OFTO transmission charges paid by the developer reflect the transfer value, so the developer has some sensitivity to the IDC, but this is limited by the circular nature of the payments and the fact that transmission assets are only a small part of the developers overall project costs.

By contrast, the cap and floor range of returns for an interconnector developer are directly affected by IDC, and it has a large lifetime impact on the whole of the project costs. This difference in risk profile and the differences in regime maturity call into question the logic of using the same approach to IDC in both sectors.

Therefore, any alignment in approach should still build in adequate recognition of the fundamental differences between OFTOs and interconnectors.

2. ***Do you agree with the alternative methodology proposed by CEPA?***

NGV has some concerns with the alternative methodology proposed by CEPA. Primarily, NGV is concerned that the new methodology does not adequately reflect the development and construction risk faced by interconnector developers.

The decision to remove the ‘Additional Uplift’, covering both development and construction risk, was taken in an Annex to the Window 2 IPA decision consultation. This fundamental regime change should be subject to its own consultation and decision making process, and NGV would welcome Ofgem reconsidering the decision in the course of this consultation. The ‘Additional Uplift’ has served as a clear, transparent, and fair way of rewarding developers for taking on feasibility, design, and construction risks.

The development risk element of the additional uplift would mitigate the risk of projects not progressing from development to construction. NGV believes that the current uncertainty arising from political risk may reduce the number of projects that are reviewed for feasibility and as a consequence may not be progressed for development. This is especially relevant as the UK and EU develop a new form of relationship on energy matters after the UK leaves the EU.

The construction risk element of the additional uplift would mitigate the risk of disallowed costs. NGV notes from a previous CEPA report [2] that there was a 20% chance of there being Risk of Unrewarded costs. No projects to date have reached the post-construction review stage - it is only at this point that developers know precisely how the C&F levels are affected by disallowed costs and the level of IDC. It is also notable that the independent NAO report[3] on the first four OFTO’s identified an average of 8% disallowance of construction costs by Ofgem.

In addition, through the evolution of the regime NGV has observed changes in policy between design and implementation. This risk has been not reflected in CEPA’s analysis. Such changes will impact on the financeability of projects, potentially reducing the number delivered.

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[2] https://www.ofgem.gov.uk/ofgem-publications/59246/cepa-report-financeability-study-cap-and-floor-regime.pdf

[3] https://www.nao.org.uk/report/offshore-electricity-transmission-a-new-model-for-delivering-infrastructure/

The proposed removal of the uplift does not appear to be fully justified within the consultation or accompanying report. While NGV agrees that the regulatory regime is maturing, it is not yet mature, and regime maturity would not in and of itself reduce or remove the systemic design and construction risks. Therefore, NGV sees no reason why the additional uplift should be removed at this stage, as the regime is not yet mature, indeed no cap and floor interconnector has yet been through the post-construction review process.

In the absence of the uplift, it would be expected that the risk profile of an interconnector project would be reflected through the equity and asset betas, set with direct reference to an appropriate comparator set. NGV does not agree that the proposed betas for interconnectors adequately reflect the real risks faced by developers. The comparator group used looks inappropriate and the beta uplift does not appear to reflect the risks identified in Annex B of the report.

The comparators used in the report have changed substantially from those used in previous reports; further clarity on why these have changed so substantially would be welcome.

Construction and engineering companies do indeed build large projects, but they are not necessarily exposed to the full impact of cost and schedule changes and their financial performance is driven only by the construction phase, rather than the full life cycle involvement of interconnector developers. Interconnectors are unique, complex projects spanning multiple jurisdictions, and many decades, the risks they face are higher than those of the comparators identified.

Indeed, the consultation recognises the difference between the comparators used and the risks of OFTOs and interconnectors by proposing to uplift the betas due to the higher risks. This is driven by a comparative risk analysis contained within Annex B of the report. This analysis clearly demonstrates that interconnectors are riskier than OFTOs, but the beta uplift for interconnectors is only slightly above that of an OFTO – this does not reflect the different risk profiles identified within Annex B.

Fundamentally, removing the additional uplift as a distinct item while adding an uplift to the betas lacks transparency. The previous approach of separately identifying and justifying the uplift is more appropriate.

Additionally, on page 38 of the report it is noted that the geometric return from DMS is used, however, on page 12 it is noted that a blend of the arithmetic and geometric means is preferred. Previously, the arithmetic mean has been the preferred approach. Clarity on which measure is to be used would be welcome.

3. *Do you agree with our minded to position to use the mid-point in the ranges produced by CEPA for OFTO's and ICs?*

NGV does not agree that the use of the mid-point figure is appropriate. When a range of values is produced, for use on a number of projects with different characteristics, it is more appropriate to use a value at the top of the range rather than at the mid-point. It is also unclear how a 'Cap' rate for IDC would apply to Interconnectors as proposed within the consultation.

4. *Is there anything else we should consider when making our final decision?*

NGV notes that interconnector projects can have a significant development phase, prior to any application to the C&F regime. Policy changes affecting projects already under development should be avoided, as this could deter further development of these projects, potentially negatively impacting consumer welfare.