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Our Reference NCB/OFGEM/DI/001

Dear Kate

Review of the methodology for the calculation of the Interest During Construction for Offshore Transmission and future Interconnectors granted the cap & floor regime ('IDC Review').

Thank you for allowing us to respond to this consultation on Interest During Construction (IDC) calculation.

We are responding on behalf of the NeuConnect project and the consortium's shareholders. This response is only intended to address the proposal in respect of interconnectors participating in the cap and floor regime.

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

   By their very nature, there are inherent differences in the characteristics of transmission investments regulated under the different regimes of (i) OFTO, (ii) Interconnectors, or (iii) Onshore Transmission. These differences include:

   (i) **Drivers for the Project.** Interconnectors and offshore generation are largely determined by project economics such as cost of generation or arbitrage in the case of interconnectors. Onshore transmission is driven by network requirements determined by NGET.
   (ii) **Separation.** Offshore Generation and Interconnectors are stand-alone discreet projects. Onshore transmission is part of a network of assets.
   (iii) **Regulation.** The regulatory regimes are different for each asset class and remain far more complex and subject to risk when interconnecting two separate energy regimes.
   (iv) **Revenue.** The revenue streams and risks to revenue streams are also very different as is the cost and period to conduct maintenance and repairs for these different transmission assets.

(v) **Technology and Construction.** The technology and construction risks are different for each asset class.

All of the above factors were recognised in Ofgem's 2011 Grant Thornton report and we do not consider that anything has changed to alter the position. The above factors have an important bearing on the risks perceived by an investor under each regulatory regime and hence the cost of capital may be significantly different for each regime and also individual projects.

The Grant Thornton report also highlighted the inherent risk of the regulatory regime of an interconnector project, in comparison to offshore transmission, which is usually ancillary to offshore wind projects with less material development risk.

The recent CEPA report (commissioned by Ofgem for this IDC consultation) also acknowledges different projects have different time horizon's, commencement dates and inherent asset risk. As also noted by CEPA, interconnectors are impacted by two different regulatory regimes between the connecting countries.

Interconnector projects are subject to project specific risks, which are a consequence of the characteristics of the individual project. The differing regulatory regime is one amongst many other factors, which explains why the Authority has previously adopted a 'project by project' approach for interconnectors. Given the different factors above have not changed, we see no need or basis to adopt a consistent approach across these different transmission assets.

CEPA comment that the Nemo project in Window 1 was a 'pilot project' and that the regime is now 'relatively mature', with six interconnectors having received approval for the cap and floor regime. However, none of these cap and floor projects are yet operational and the majority have yet to start construction. The Nemo and NSL projects are also TSO backed and balance sheet financed projects (rather than project financed projects). Each of these projects are structured differently and subject to different regulatory regimes in both Belgium and Norway, which underlines the project by project approach. As neither project is yet in operation, then it is premature to state that there is now greater clarity over Ofgem's approach to interconnector project assessment and hence no risk premium is required for this asset class.

The guidance provided by Ofgem for the Cap & Floor regime states that IDC 'methodology is based upon an approach used for offshore transmission with two additional uplifts for interconnectors to 'compensate for greater project development risk; and uncertainty around cost disallowances'. Therefore, Ofgem have themselves always recognised the differences in these two network assets and as no cap & floor project has been completed yet, there appears no basis to remove any premium for development risk or cost disallowance.

The scale of spend and risk for interconnectors are very different from those for OFTO's and any competitive onshore transmission projects. This makes the debt required and risk to cover the level of debt more difficult than with smaller less complex, shorter build, single regulatory regime assets. We will expand further on the debt issues under point 2 below.

For the reasons given above, the OFTO regime, Competition Proxy model and the Interconnector Cap & Floor regime are different in their regulatory treatment, engineering, scale of project and risk profiles, so we do not agree with alignment of the IDC for each of these network assets. The CEPA report does not change our view on the distinctions between assets and so we do not see a reason for alignment as suggested.

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

The CEPA model derives an estimate of WACC by the application of an asset model and benchmark indexes.

Capital intensive and long-term projects that seek to raise private financing on a stand-alone basis and with no recourse to the sponsors' balance sheets, need to feature cash in and outflows that are as predictable as possible over the life of the asset. As a consequence, senior debt is typically raised on a long-term basis covering both the construction and as much of the (if not the entire) operation phase of the project.

Splitting the financing into a construction bridge loan and an anticipated refinancing thereafter, would therefore not follow established market practice for funding infrastructure and energy projects and create additional uncertainties for investors and lenders alike. Such uncertainties would need to be priced-in by the different classes of capital providers, resulting in higher project costs and no immediate benefit for consumers. The question whether

there is a long-term benefit for the consumers can only be answered in the light of the prevailing capital market conditions at the time of the refinancing.

Further, non-recourse project financing is typically structured to keep the project company clean of the risk of changes to market interest rates during its life. Otherwise, the project would face the risk of a funding shortfall during the construction period or a cash shortfall to service its debt during the operation phase.

Consequently, at financial close of the financing, non-recourse lenders will require the project company to take-out an interest rate swap, the tenor of which is commensurate with the life of the senior loan instrument. Splitting such a hedging product in two swaps (one for the construction period and one for the operational phase) would, as with the loan itself, result in higher costs and therefore is deemed inefficient and not necessarily value for money.

For these reasons, we do believe that the choice made by CEPA to consider a benchmark with a tenor matching solely the construction period is inappropriate for interconnectors aiming at raising non-recourse financing. Instead, such a benchmark would need to be based on the maturity of the long-term swap rate applicable to the overall financing's loan life.

In any case, we are of the view that the suggested benchmark does not reflect the real risk profile of interconnector projects. As explained above, the interconnector sector and, more generally speaking, offshore construction methods and technologies for these assets cannot be considered as mature for the time being. We acknowledge that the greater clarity on Ofgem's approach to interconnector project assessment certainly provides more comfort to investors regarding the regulatory framework (and yet the framework applicable to one half of the project's costs and revenues only), however the construction risks in a maritime environment under difficult weather conditions for offshore interconnectors are not yet fully understood by investors and capital markets.

The overall risk profile of interconnector projects during the construction phase would thus hardly qualify as investment grade. Therefore, we disagree with CERA's position that "for all asset classes, the low end of the range should reflect a combination of A and BBB rated debt, while the upper end of the range should be based on BBB rated debt. This reflects our view that the qualitative features of each regulatory regime would provide a reasonable

basis for assuming a cost of debt equivalent with an investment grade rating during the construction period."

In its letter dated 16 December 2015 concerning financing of interconnectors under the cap and floor regime, Ofgem provides an example of a possible variation that could be attractive for private financing of interconnectors being the use of actual cost of debt, as opposed to iBoxx. Using the actual cost of debt then provides a clear and transparent debt cost for the project and does not require a calculated or benchmarked rate. The actual cost of debt can be determined in a transparent way at FPA stage prior to financial close and reflect the actual cost of debt at pre-commencement of construction of the interconnector when finance is raised.

Investors require an economic and efficient return taking into account the risk to which each individual project is exposed in development, construction and operation. Therefore, in order to attract private finance and bring new competition into the interconnector market there needs to be transparency and predictability to the cost of debt methodology, such that licence holders are able to finance the activities which are subject to its licence. A tailored methodology is required to provide project specific cost of capital for each project and transparency to consumers of the overall costs and benefits to be derived of the particular project. Equally the regime in which investment is made needs to remain stable, without continual adjustment through different consultations which creates additional risk for investors developing a project.

Considering the uncertainties surrounding exit from the EU, varying inflation levels, large variances in currency exchanges and volatility of prices around raw materials together with recent contractor insolvencies and a heightened awareness of construction risk, then the use of models and indices creates greater uncertainty to investors in large infrastructure projects.

As noted in the response to question 1 previous IDC rates for Window 1 Cap & Floor projects have provided uplifts for project development risk and construction related cost assessment process uncertainty. The cap & floor regime has not been amended to eliminate either of these risks and no projects in this asset class are yet operational to allow a better assessment of the risks associated with the regime.

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

   For the reasons given under 2. Above, we do not agree with the methodology proposed.

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

   The cap & floor regime needs to recognise the needs and demands of privately financed projects as well as TSO supported balance sheet projects to attract new investment and entrants into the market, while at the same time acknowledging their differences in capital structure and funding sources. The recognition of actual costs of debt would be a way to recognise these differences, while allowing one regime capable of addressing all projects' funding structures.

If you have any further questions or would wish us to supplement our responses above with further information, please do not to hesitate to contact me.

Yours sincerely

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