

Interconnector developers,
investors, financial lenders and
other interested parties.

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Dear stakeholders

Enabling a range of financing solutions under the cap and floor regime

This letter sets out our guidance to interconnector developers who are considering requests for variations(s) to the cap and floor regime related to financing. This guidance applies to both the projects which came through the first cap and floor application window as well projects that will be submitted through our second application window.

We are publishing this letter alongside a letter of support from the European Investment Bank (EIB) setting out that the bank intends to offer a range of financial products to support financing of interconnection to UK¹. We would be open to arranging specific discussions with developers on this.

Background

In August 2014² we rolled out the cap and floor regime to near-term electricity interconnectors and with immediate effect opened the first application window. In March 2015 we confirmed our cap and floor approach to future interconnection as part of our Independent Transmission Planning and Regulation (ITPR) policy conclusions³ and committed to opening further application windows in the future. We have recently announced that we will open a second application window between 31 March and 31 October 2016⁴.

As part of our current policy, developers may request regime variations provided they can demonstrate that these are in the interests of GB consumers. One of the reasons we adopted this policy was to reflect stakeholder feedback suggesting that certain aspects of the default regime may be less suitable for some types of financing solutions. In May 2015 we also published an open letter⁵ inviting interested parties to engage with us on the financing of electricity interconnectors under the cap and floor regulatory regime. The aim of this initiative was to develop our understanding of the fit of our existing cap and floor

¹ Letter of support from the European Investment Bank - <https://www.ofgem.gov.uk/publications-and-updates/enabling-range-financing-solutions-under-cap-and-floor-regime>

² Decision to roll out cap and floor regime to near-term interconnectors - <https://www.ofgem.gov.uk/publications-and-updates/decision-roll-out-cap-and-floor-regime-near-term-electricity-interconnectors>

³ ITPR: Final conclusions - <https://www.ofgem.gov.uk/publications-and-updates/integrated-transmission-planning-and-regulation-itpr-project-final-conclusions>

⁴ Decision to open a second cap and floor application window - <https://www.ofgem.gov.uk/publications-and-updates/decision-open-second-cap-and-floor-application-window-electricity-interconnectors-2016>

⁵ Open letter on financing electricity interconnectors under the cap and floor regulatory regime - <https://www.ofgem.gov.uk/publications-and-updates/open-letter-financing-electricity-interconnectors-under-cap-and-floor-regulatory-regime>

regulatory model with different financing options, and areas in which amendments to that model may enable greater alignment in future.

We have since engaged with a number of stakeholders (investors, lenders, developers etc) and received feedback on the aspects of our regime that might be less suitable for alternative funding solutions such as project finance. We would like to thank those that took part for their input.

Guidance to the regime variations

We consider that enabling alternative sources of finance such as project finance is, in principle, in the interests of GB consumers as it provides access to a broader pool of capital, as well as promotes competition in the interconnector market. Our recent stakeholder engagement has been helpful and clarified areas where the default regime (see Annex I for summary) may benefit from variation to allow different financing solutions to be accessed. To reiterate our final cap and floor policy decision published in August 2014, we welcome developers requesting regime variations where they are likely to be in the interests of GB consumers.

We are issuing this guidance in order to help developers who may wish to ask for regime variations relating to financing. This includes our high level principles for assessing such requests from developers. The guidance will apply to both the existing projects which have already been assessed as part of the first application window process as well as projects which will apply through our second window. In addition, in Annex II we provide some regime variations relating to financing which we understand developers may consider requesting and associated considerations we may have in analysing such requests.

Assessing requests for regime variations

We will consider requests for adjustments to aspects of the cap and floor regime on a project specific basis and project developers need to demonstrate that any regime variations are in the interests of consumers. In making our determination of the impacts on consumers, we will include the impact on the consumer welfare and liability (e.g. the floor). When assessing variations, we will base our decision on their cumulative impact.

Requirements for requests

As a general principle, developers should submit their requests when they have sufficiently robust information to provide to us so that we could conduct our assessment. Submissions which are incomplete will not be assessed.

As a minimum, we require the developers to provide us with the following information as part of their submissions:

- Rationale for each variation requested, including evidence where appropriate as to why it is needed.
- Qualitative and quantitative assessment of cumulative impacts on consumers as a result of regime variations suggested. This should include a GB social welfare assessment for the variations requested and a comparison against the default regime as the counterfactual.
- Adjusted cap and floor financial model⁶, reflecting the regime variations requested.
- Where changes to the cost of debt are requested, a full plan of how you expect to ensure the most competitive funding solution including details of any funding competition. In addition, we would like to see evidence that the project will be efficiently structured to obtain the highest possible credit rating, where appropriate.
- For any regime variations, you should provide detailed supporting evidence for the change. For example, head of terms to support a change to the cost of debt index

⁶ The standard cap and floor model is available on request.

or move to using an actual CoD (which may include bank margins, credit spread and what the respective costs are applied to e.g. interest rate swap or GILT rate).

Request timings

Developers can decide the specific timing of submission based on their project specific circumstances. However, developers should bear in mind that the timelines of our current processes (e.g. timing and duration of the FPA) will have to be respected. This means developers should make sure that requests for variations are closely aligned with the current cap and floor regime processes. In particular, where relevant, developers should allow sufficient time for Ofgem to assess and consult on regime changes, and where appropriate for developers to run a funding competition to allow the cap and floor to be set as part of our final FPA decision.

Developers should give us at least three months' notice before submitting any variation requests and we encourage developers to discuss the timings of their submissions with us. We will aim to assess requests as soon as possible, but the length of our assessment will depend on the nature and the complexity of variations requested. We intend to provide developers with indicative timelines based on the specific circumstances of their request. We will aim to assess any requests within six months which will then be followed by a public consultation process.

Potential regime variations relating to financing (see Annex II for detail)

Types of variations which we may consider could include, but are not limited to, a change in how we calculate the cost of debt or a change in the revenue assessment period. In order to inform developers' thinking on the potential variations and the considerations that may arise, we have provided some initial views in Annex II.

Next steps

We are open to discussing the content of this letter with developers and other interested parties in person. We specifically encourage developers that are considering requests for regime variations to notify us in accordance with the timelines set out above.

Through our further engagement with relevant parties we may also update this information as a result.

If you have any questions about the content of this letter, please get in touch with us either via email (cap.floor@ofgem.gov.uk) or by contacting Andrius Cialka directly on 0207 901 3124.

Yours faithfully,

Steve Beel
Associate Partner, Electricity Transmission

Annex I – Summary of financial aspects of the default cap and floor regime

The table below provides a summary of the key financial aspects of the default cap and floor regime for the first and second application windows. For the latest description of the default regime, please refer to our May 2014 consultation⁷ and August 2014 decision letter⁸.

Table 1: High level summary of the key regime parameters relating to financing

The key default regime parameters relating to financing	
Profile	Flat real cap and floor profile over the length of the regime (25 years).
Floor calculation	RAV (including IDC) annuitized at a cost of debt benchmark, plus allowances for opex, decommissioning and tax.
Floor cost of debt benchmark	Based on a cost of debt A/BBB benchmark that is applied to 100% of the RAV. This parameter is calculated using a 20-day trailing average of the GBP Non-Financial iBoxx index of 10+ years to maturity with a credit rating of A/BBB. Inflation is based on 10-year breakeven inflation data published by the Bank of England.
Cap benchmark	This is based on the Capital Asset Pricing model (CAPM). We will use the risk free rate and equity risk premium as determined by our methodology at the time. The equity beta at 1.25 based on our assessment of risk at the cap (we consider this to be similar to the risk faced by an independent generator).
Gearing	No assumption is made about the level of gearing achieved for the purposes of calculating allowed returns at the cap and floor.
Revenue assessment periods	Five year, discrete basis (each five year period is considered in isolation). Cumulative revenue during the five years will be assessed against the cumulative cap and floor at the end of the period. Please note, that after a five year revenue assessment period, no regime parameters change.
Within assessment period payments	Possibility for payment within the assessment period at the cap or floor subject to Ofgem decision based on justified financing need by the project developer.
Indexation of the cap and floor	For Window 1 - 100% indexed by UK RPI. For Window 2 - we are currently inviting views from stakeholders on a move to the Consumer Prices Index (CPI) as an inflation index, the outcome of which will apply to developers applying in the second window. ⁹
Interconnector Availability (cap and floor)	Cap levels can vary by +/-2% if interconnector availability exceeds or falls short of a target availability. This target availability is set on a project by project basis according to our established methodology. Developers will lose eligibility for floor payments for each individual year if availability is below an 80% threshold (except for certain allowable events).
Financial assistance & refinancing	Any grants (e.g. from the Connecting Europe Facility) would be net off the project investment costs that are used to set the final cap and floor levels (ie ahead of operation). Refinancing gains do not impact the calculation of the cap and floor once set.

⁷Proposal to roll out cap and floor regime to near-term interconnection projects:

<https://www.ofgem.gov.uk/publications-and-updates/regulation-future-electricity-interconnection-proposal-roll-out-cap-and-floor-regime-near-term-projects>

⁸ Decision to roll out cap and floor regime to near-term interconnectors - <https://www.ofgem.gov.uk/publications-and-updates/decision-roll-out-cap-and-floor-regime-near-term-electricity-interconnectors>

⁹ Indexation for future OFTO and interconnector licences: <https://www.ofgem.gov.uk/publications-and-updates/indexation-future-ofto-and-interconnector-licences>

IDC	<p>Interest During Construction (IDC) is treated as a cost in the construction phase and applied to the pre-operational cost (ie added to the RAV). The IDC calculation methodology is based on approach used for offshore transmission with two additional uplifts for interconnectors to compensate for: greater project development risk; and uncertainty around cost disallowances.¹⁰</p> <p>For Window 2, we may review the IDC rates and treatment following our current IDC review for OFTOs.¹¹</p>
Sharing factor	<p>The default cost and revenue sharing factor is 50%. This means that 50% of total project costs are used for setting the cap and floor levels and 50% of total interconnector revenues are regulated under the GB regime.</p>

¹⁰ For more detail on the IDC calculation, including the proposed comparator companies, please see the 2013 consultation on IDC for the Nemo project which can be found here: <https://www.ofgem.gov.uk/publications-and-updates/offshore-electricity-transmission-and-interconnector-policy-minded-position-interest-during-construction-idc>

¹¹ Proposed Interest During Construction for offshore Transmission: <https://www.ofgem.gov.uk/publications-and-updates/proposed-interest-during-construction-offshore-transmission>

Annex II – Examples of potential regime variations relating to financing

Below we set out some examples of variations to the default regime (see Annex I) that we understand from our stakeholder discussions that developers may want to request specifically in relation to financing matters. We also set out some of the associated considerations we might take into account when assessing such requests. The list is not intended to be exhaustive. Developers can still request variations they think appropriate, but they will still need to show why such variations would be in the interests of GB consumers, including what value is derived from the level of support offered.

Table 2: Examples of potential regime variations

Variation	Description
Using actual project CoD in the floor calculation	The default regime utilises a cost of debt benchmark in order to set what we consider to be an appropriate level of regulatory support. We recognise that for project finance in particular, projects may prefer to have an actual cost of debt utilised in the floor calculation to provide greater transparency and certainty. We would be open to considering utilising the actual cost of debt raised for a project in calculation of the floor, but would look for assurance that this still represented an efficient overall outcome. For example, we may want to ensure a fully transparent funding competition is run to ensure the optimal debt cost and financing structure are achieved. We also recognise that the actual project CoD will depend on the credit rating of a project and therefore, as part of our assessment, we would also look to ensure a project is structured appropriately.
Interest during construction (IDC)	Where actual project CoD is used instead of iBoxx it might be desirable to use actual project CoD rate for the purposes of calculating IDC. This would help the developers to ensure that CoD in the IDC calculation reflects the actual CoD at pre-construction stage.
Shorter revenue assessment period	Some interconnector owners might favour a shorter revenue assessment period as it would fit better with the financing structures they choose to adopt and specifically the repayment terms that would be efficient. In particular, we anticipate that developers may request a change from five yearly to annual revenue assessments.

Considerations in relation to such changes

We have set out above a limited number of potential changes which we think are important to project finance structures in particular. We are aware that this relatively limited number of changes may lead to further considerations to ensure the cap and floor mechanism remains appropriate and in consumers' interests. Below we outline some of these considerations such that developers may consider them as they work towards putting together any requests for variations to the default regime:

- Impact on the level of equity returns at the floor of changes to the cost of debt utilised:** the default regime may provide for equity returns at the floor dependent on how the actual cost of debt raised by a project compares to the benchmark level. Whilst we expect that efficient projects should not expect to be operating with revenues at the level of the floor, we recognise the sensitivity of equity investors to their returns in these downside scenarios. Moving to using an actual cost of debt, which would naturally be sensitive to the level of gearing a developer chooses, may require us to consider whether the CoD should still be applied to 100% of the RAV. If it is, we would need to ensure that this creates the right incentives for developers to create the optimal financial structure. If not, we would need to consider what level of support it would be appropriate for equity investors to receive at the floor. For the construction phase, we would also need to consider whether it was still appropriate to calculate an implied equity return or whether we should look at project specifics to reflect the actual cost of debt.
- Interaction of refinancing with use of an actual cost of debt:** as the default regime does not explicitly reflect project specifics in terms of the cost of debt

benchmark, it does not apply any mechanisms in relation to refinancing. If we were to use an actual project cost of debt in setting the floor we would need to consider how refinancing activity was reflected, both specifically at the end of the construction phase, but also generally under other scenarios where a refinancing may be efficient. A refinancing mechanism could share the gains of a refinancing either through lowering the relevant cost of debt used in setting the floor and/or taking account of any one-off sharing of the gains of a refinancing in assessed revenues.

- **Ensuring developers remain incentivised and maximise availability:** where a developer wished to move to an annual revenue assessment this could reduce the incentives on developers to maintain interconnector availability in a year where revenues are high, because all revenues above the cap are returned to consumers. It may be appropriate to consider a change to the revenue sharing mechanism above the cap to avoid this. However, introducing such sharing mechanism may also require a change to the level of the cap (i.e. set at a lower level) in order to reflect the potential increase in returns this makes available to a developer. Similarly, we could also consider changes to the incentivisation of developers at the cap in return for proposals aimed at minimising consumer liabilities at the floor, which could also create a case for sharing mechanisms above a pre-defined cap where appropriate.