



Making a positive difference
for energy consumers

Offshore wind farm developers
and other interested parties

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'IDC Review' in the subject heading)

Dear colleague

**Proposed Interest During Construction for
Offshore Transmission**

Date: 9 December 2015

1. Overview

Developers of generator build offshore transmission assets invest capital during the planning and construction phase with no return on this investment until the project is complete. In determining the final asset values that developers receive when the ownership of the assets is transferred to Offshore Transmission Owner we include the efficient cost of capital for construction through Interest During Construction (IDC). IDC is accrued on the actual cash flow when payments are made against the contracts for developing and constructing the transmission assets. We have determined that IDC should be allowed up to the point where the transmission assets are available for use for the transmission of electricity.

Ofgem determines the efficient cost of capital for construction of those assets by allowing for the application of a cap for IDC. In December 2013, we committed to annual reviews of the IDC cap to reflect current market conditions, with the latest capped rate being set at 8.00%¹ for the 2015-16 financial year.

This letter presents the capped rate of IDC Ofgem is minded-to apply to offshore transmission for the 2016-17 financial year being 7.44%, which would be applied to all assets that reach final investment decision (FID) during that period. We would like to invite interested parties to respond to the position set out in this letter by 29 January 2016.

2. Approach

We propose to apply the same methodology for calculating the forthcoming IDC as we used in setting the rate applied for 2014-15 and 2015-16. This involves deriving an estimate of the Weighted Average Cost of Capital (WACC) by applying the Capital Asset Pricing Model (CAPM) as set out in Ofgem's decision document of 18 December 2013.

The updated IDC reflects an update of the standard input metrics used for the CAPM to reflect current market conditions. All input variables have been updated to reflect current values. These inputs are listed below in Table 1 which also indicates the sources of the actual values used.

¹ Pre-tax nominal

3. Findings of the IDC Review/Calculation of the CAPM

The table below illustrates the updated values for offshore transmission. These figures are based on input parameters as of 31 August 2015 as compared to one year prior.

Table 1: Indicative values for input parameters of IDC rate

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%	

The magnitude of overall change from the previous IDC cap of 8.00% (as there was no material change for the 2015-16 financial year cap) is material with a 0.56% decline in the prevailing IDC capped rate.

The minded-to capped rate of 7.44% has been derived using the following parameters:

Gearing: Derived from the set of comparator companies used in previous decisions;

Equity Beta: Derived from the set of comparator companies used in previous decisions;

Market Risk Premium: Credit Suisse Global Investment Returns Sourcebook

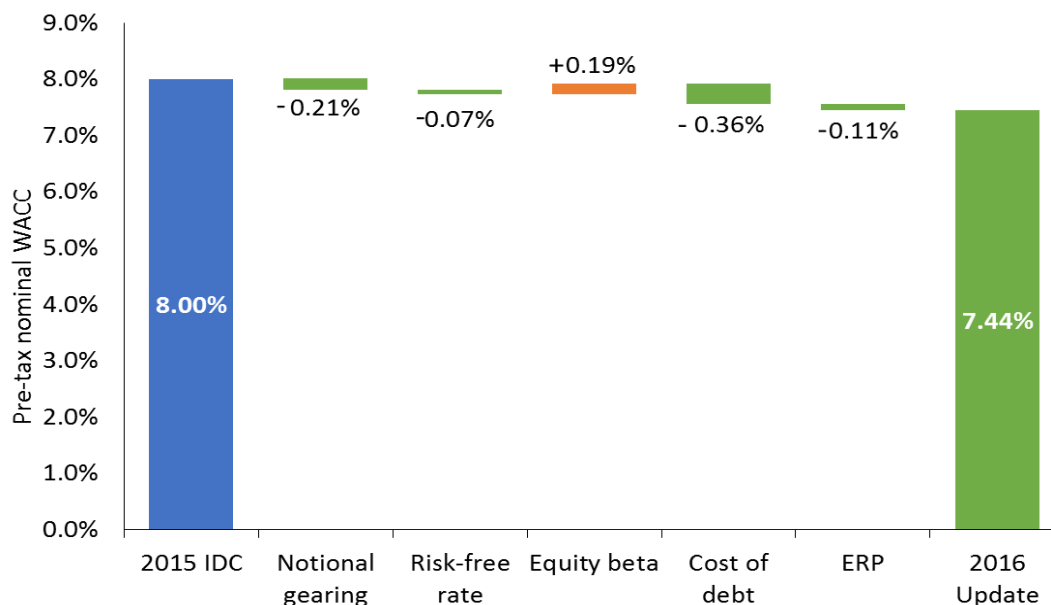
Cost of Debt (nominal): This has decreased by updating the historical trailing average data;

Risk-Free Rate (nominal): Decrease by updating the historical trailing average data;

Tax Rate: tax rate (20%) unchanged.

Overall, these changes to each of the input parameters are illustrated in the diagram below:

Figure 1: Diagram illustrating changes to capped IDC as a result of updated input parameters for the financial year 2016-17



As the updated input values indicate a current rate materially lower than that decided upon last year, we are minded to update the cap for the financial year 2016-17 to 7.44%.

4. Application

Cap on IDC

We intend to continue to apply a cap rather than a fixed rate to the IDC for offshore transmission.

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

We also intend to fix IDC at FID for the duration of the project, so that IDC will be fixed until construction of the project is complete.

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.

5. Responding and Next Steps

Ofgem welcomes the views of interested parties in relation to the updates set out in this document. Please also send us supporting evidence to substantiate your views by 29 January 2016. We intend to reach a decision on the matter soon thereafter.

Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. Respondents are asked to put any confidential material in the appendices to their responses.

Responses should be sent to:

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Yours sincerely,

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