Offshore wind farm developers,
interconnector developers and
other interested parties

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Dear colleague

Decision on Interest During Construction for Offshore Transmission and interconnectors granted the cap and floor regime, to apply during 2017/18

1. Introduction

This letter sets out our decision on the Interest During Construction (IDC) rate for offshore transmission and electricity interconnectors under the cap and floor regime, to apply during 2017/18.

Following a public consultation process and a careful consideration of the stakeholders' views submitted to us, we decided the following:

- Offshore IDC – to confirm the IDC cap rate at 6.83% (pre-tax, nominal) for offshore transmission projects reaching Final Investment Decision (FID) during 2017/18.
- Interconnector IDC – for projects which have already received an IPA decision by Ofgem (window 1 projects), we will continue to set the IDC on a project specific basis at the time of FID.
  We intend to consider further the mechanism of setting IDC for projects which have yet to receive an Initial Project Assessment (IPA) decision by Ofgem (window 2 projects), and will present our conclusions as part of our window 2 Initial Project Assessment Consultation, which we are aiming to publish in the middle of June 2017.

The sections below summarise our consultation process and provides further detail on our decisions.

2. Overview

On 21 December 2016, we published our consultation - "Proposed Interest During Construction for Offshore Transmission and proposal to extend annual methodology to interconnectors granted the cap and floor regime"[1]. We received three responses to the consultation and this letter serves to summarise those responses and to set out the decisions which we have reached.

We proposed to move to annual updates of IDC for electricity interconnectors and to align the calculation inputs with those for the OFTO IDC. This would have involved changing the timing of setting interconnector IDCs from individual assessments at the date of FID for each project to an annual update applicable to all projects reaching FID in that year. It

[1] https://www.ofgem.gov.uk/system/files/docs/2016/12/minded-to_letter_idc_for_ic_and_ofto.pdf

would also have included some changes in the detail of the interconnector IDC to match the OFTO calculation wherever possible. We explained that this would provide greater simplicity, transparency and certainty by comparison with the current policy. Although some differences would remain between the two calculations since development risk and construction risk premiums are applied to interconnector IDC, but not to OFTO IDC; and OFTO IDC is quoted as a pre-tax nominal rate while interconnector IDC is quoted as a vanilla real rate.

Our minded-to position as set out in our 21 December 2016 letter was to set capped rates of IDC for the 2017-18 financial year (April 2017 to March 2018) for OFTOs at 6.83% (pre-tax, nominal), and for interconnectors within the cap & floor regime at 5.10% (vanilla, real), to apply to all assets that reach FID during that period.

3 Summary of consultation responses

This section summarises the responses from stakeholders that have helped to inform our decisions. We received three non-confidential responses to the consultation. These responses were from FAB Link Limited, National Grid Interconnector Holdings Limited, and Scottish Power Renewables.

Our consultation letter of 21 December 2016 did not ask any specific questions but invited comment on the proposal as a whole or any part thereof. We summarise these responses according to the topics raised by the respondents.

3.1 Extending the principle of setting an annual rate for IDC to include cap & floor interconnectors as well as OFTOs

Summary of the responses

One respondent said that they had no objection to the idea in principle, another welcomed the proposal in one part of its response, while criticising it in another.

One respondent argued, in general, that the position set out in the consultation would have a significantly detrimental effect on some interconnector projects that are yet to take FID with our proposals resulting in a lower IDC rate. They requested Ofgem to maintain the pre-existing calculation methodology.

They considered that the consultation had not made clear the degree which the reduction in IDC rate was due to market movements, and what was due to changes in methodology. As all window 1 projects have had their IDC calculated individually at the time of their FID each set of changes is specific to that interconnector. Ofgem has provided this respondent with a worked example showing how our proposals would affect the interconnector which it is developing, illustrating both changes as a result of market movements and those stemming from our proposed methodological changes.

Our view

In order to provide regulatory certainty for the projects already approved, we have decided to maintain the original methodology for projects already approved as part of the first application window (Window 1 projects).

Furthermore we wish to re-examine our minded-to position in relation to interconnectors which have yet to achieve an Initial Project Assessment decision by Ofgem (Window 2 projects). Therefore there is no change to the existing arrangements for setting interconnector IDCs at present and this decision document serves only to set IDC rates for OFTOs.

3.2 Setting a rate cap for offshore transmission

Summary of the responses

Two respondents expressed concern that we set IDC rates as rate caps for offshore transmission. One of them considered that OFTO IDC rates should not be lower than the project return for the wind farm development as a whole.

Our view

Setting an IDC rate as a cap allows us to use a company's actual rate of return rather than the cap rate where that company informs us that its return is lower than our cap. The IDC rates which we are setting are intended to be sufficient to allow the financing of the construction of transmission links and they do not relate to internal project rate of return targets set by developers.

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

3.3 Reflecting disallowed costs

Summary of the responses

One respondent considered that IDC rates should be adjusted to compensate for Ofgem's disallowing inefficient costs.

Our view

This issue was addressed in our 2013 consultation[2]. In reaching our Decision on that occasion we stated:-
"Ofgem does not accept that the disallowance of uneconomically or inefficiently incurred costs creates asymmetric risk that should be rewarded. Ofgem has set out clear cost assessment principles in the guidance and published cost assessment reports for all offshore transmission projects, setting out rationale for any disallowances and making our cost assessment process transparent. The October consultation explained that, to reward inefficient costs would reduce the effectiveness of cost assessments and disallowances that aim to encourage economic and efficient behaviour. We therefore do not accept the argument that disallowance of inefficient costs raises any legitimate need for an increase in efficient financing costs reimbursed through IDC."
Our view remains unchanged.

3.4 Equity Risk Premium

Summary of the responses

Two respondents criticised the proposed changes which would result in a lower rate of IDC for interconnectors. One of whom contrasted the proposed approach with the calculation previously applied to interconnectors as follows:-

"The existing Cap & Floor methodology sources Total Market Returns (TMR) from the Credit Suisse Source Book and then calculates the market risk premium arithmetically by subtracting the risk free rate and UK RPI adjustment. The newly proposed methodology

[2] https://www.ofgem.gov.uk/sites/default/files/docs/2013/12/decision_on_approach_to_idc_offshore_transmission.pdf

reads the market risk premium directly from the Credit Suisse Source Book which is then reduced to account for the tax rate. This leads to a reduction in the like for like market risk premium of approximately 10% which is not explained in the consultation document."

The other respondent queried the use of the World Index, rather than the UK only equivalent because the UK value is higher than the World value.

Our view

Our intention is to make use of the consistent data set and calculations available in the Source Book and to make as few adjustments as possible.

We consider it appropriate to make ae few internal adjustments to these calculations as possible by making full use of the Credit Suisse Source Book.

Making use of the parameters in the equity cap calculation would require a reassessment of the UK RPI adjustment from 0.4% to around 1% where it has stabilised for all the projects yet to be approved. Such a change would be equivalent to a 10% reduction in market risk premium.

In setting OFTO IDC we observed that offshore windfarm developers were global companies capable of investing in opportunities wherever they occurred. The assets might be in the UK but the investors were not necessarily so, hence the use of worldwide return data is appropriate. Equally interconnector development can attract investors of global reach, such as National Grid, and we would propose to use the same data table for both calculations.

3.5 Gearing and Equity Beta

Summary of the responses

One respondent considered that it had not been made clear how gearing and equity beta would be updated and that it had been assumed by this respondent that they would be held constant.

Our view

These parameters, as with all others forming part of the IDC assessment, were intended to be updated periodically.

- For OFTO IDCs the annual update is as set out in this document.
- For the interconnector projects having already received an IPA decision by Ofgem, these values will be updated on a project specific basis at the date of FID.
- For interconnector projects which have yet to receive an IPA decision by Ofgem we are reserving our position pending further consideration.

The updated values for OFTOs for 2017/18 are set out in Appendix 1.

3.6 Comparator Company Group

Summary of the responses

Two respondents queried the application of the comparator group companies used for OFTO IDC to interconnector IDC, pointing out that for NEMO, the first cap & floor interconnector project, the comparator group was clearly specified to be a small set of integrated utilities (Centrica Plc, E.ON AG, RWE AG and SSE PLC).

Our view

In presenting our proposals for IDC for OFTOs and project NEMO in October 2013[3] we suggested that we would adopt different comparator groups of companies, as recommended by our consultants, Grant Thornton.

However, in our Decision document in December 2013[4] we modified our position in relation to OFTOs choosing instead to make use of the same comparator group as had been proposed by Grant Thornton for interconnectors. This aligned the two project types with the same group of comparator companies.

In setting the OFTO rate for 2015/16 we accepted the advice of Deloitte and CEPA, our financial advisors for Tender Round 3 and extended the comparator group in relation to the assessment of equity beta as this relatively unstable parameter was excessively variable using the original group[5].

- Our Decision is to continue to use the modified comparator company groups for OFTOs.
- For interconnector projects already approved, we will maintain the original comparator groups for both equity beta and gearing calculations as set out in our Nemo IDC consultation and Grant Thornton's recommendations. Having weighed up the relative benefits of providing regulatory certainty while employing an inferior comparator group against the converse positon we consider that the former, as argued for by the respondents, is preferable.
- For cap and floor interconnector projects which have yet to be approved we are reserving our position pending further consideration.

3.7 Debt averaging period

Summary of the responses

Two companies queried the proposed debt averaging period. One was concerned that the 20 day period was to be extended to 2 years. The other considered that as the construction period of offshore transmission is lengthening as windfarms are progressively sited further from the shore the averaging period should be extended.

Our view

The purpose of the averaging period is to reflect the period in which debt would be raised by the operator in advance of FID, not the period of construction after FID. IDC is applied to all periods of construction as long as the build process is economic and efficient so the longer construction periods of longer transmission lines is already catered for.

- Our Decision is to leave the OFTO averaging period unchanged.
- For interconnector projects already approved, we will maintain the current shorter period.
- For cap and floor interconnector projects which have yet to be approved we are reserving our position pending further consideration.

3.8 Debt rating

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[3]https://www.ofgem.gov.uk/sites/default/files/docs/2013/10/proposedinterestduringconstructionapproachoffshoreandnemo_0.pdf
[4]https://www.ofgem.gov.uk/sites/default/files/docs/2013/12/decision_on_approach_to_idc_offshore_transmission.pdf
[5]https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/20141107_draft_decision_letter_idc_as_20141202_2.pdf

Summary of the responses

One respondent challenged the use of the average of A and BBB bonds rather than BBB alone because this was proposed for NEMO, initially in the consultation - Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO[6] and subsequently confirmed in the related decision document[7].

Our view

While the NEMO consultation referenced above proposed the use of BBB bonds alone the subsequent 2014 Decision document opted for the use of the A and BBB average as shown in Table 5.3 of that document[8]. This will continue to be the basis of IDC for those interconnectors which have already received an initial project assessment. The respondent noted that the 2013 consultation was the last that they could locate on this subject but in fact the issue was raised again during 2014 and altered as noted above.

Our decision is to:-

- Leave the OFTO ratings unchanged (the average of A/BBB).
- For interconnector projects already approved, we will maintain the current rating levels (the average of A/BBB).
- For cap and floor interconnector projects which have yet to be approved we are reserving our position pending further consideration.

4 Our decision

Following our analysis of the three responses to our 21 December 2016 consultation we have decided to do the following:

For OFTOs: to apply the IDC rates as set out in our minded-to position. That is to set capped rates of IDC for the 2017-18 financial year (April 2017 to March 2018) at 6.83% (pre-tax, nominal).

For interconnectors having already received an IPA decision by Ofgem (Window 1 projects) we will continue to assess IDC, individually, at the date of FID.

For cap and floor interconnector projects which have yet to be approved (Window 2 projects) we will present our conclusions as part of our window 2 Initial Project Assessment Consultation, which we are aiming to publish in the middle of June 2017.

Yours faithfully,

Min Zhu
Associate Partner, Networks
Appendix 1: Calculation of the OFTO IDC cap rate for 2017/18

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6 https://www.ofgem.gov.uk/ofgem-publications/59243/cap-and-floor-regime-regulated-electricity-interconnector-investment-application-project-nemo.pdf

7 https://www.ofgem.gov.uk/sites/default/files/docs/2013/10/proposedinterestduringconstructionapproachoffshoreandnemo_0.pdf

8 https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/final_cap_and_floor_regime_design_for_nemo_master_-_for_publication_1.pdf

Table 1 below sets out the updated values for offshore transmission. These figures are based on input parameters as of 31 August 2016 as compared to one year prior.

Table 1: values for input parameters of IDC rates

Component	Parameter	2016-17	2017-18	Source
A	Cost of debt (nominal and pre-tax)	4.29%	3.86%	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)	3.41%	3.12%	Ten year average of ten year gilt spot yield
C	Market risk premium	4.50%	4.40%	Credit Suisse Global Investment Returns Sourcebook
D	Equity beta	0.92	0.93	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)	7.55%	7.22%	
F	Gearing	38.70%	41.22%	Comparator companies
G	Tax rate	20.00%	19.00%	HMRC
H = A x F + E x (1 – F) x 1 / (1 – G)	**Pre-tax WACC (nominal)**	**7.44%**	**6.83%**	**IDC cap for OFTOs**

The magnitude of overall change from the previous IDC cap for OFTOs of 7.44% is material with a 0.62% decline in the prevailing IDC rate.

The capped rate of 6.83% 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;

Equity Risk Premium: Credit Suisse Global Investment Returns Sourcebook

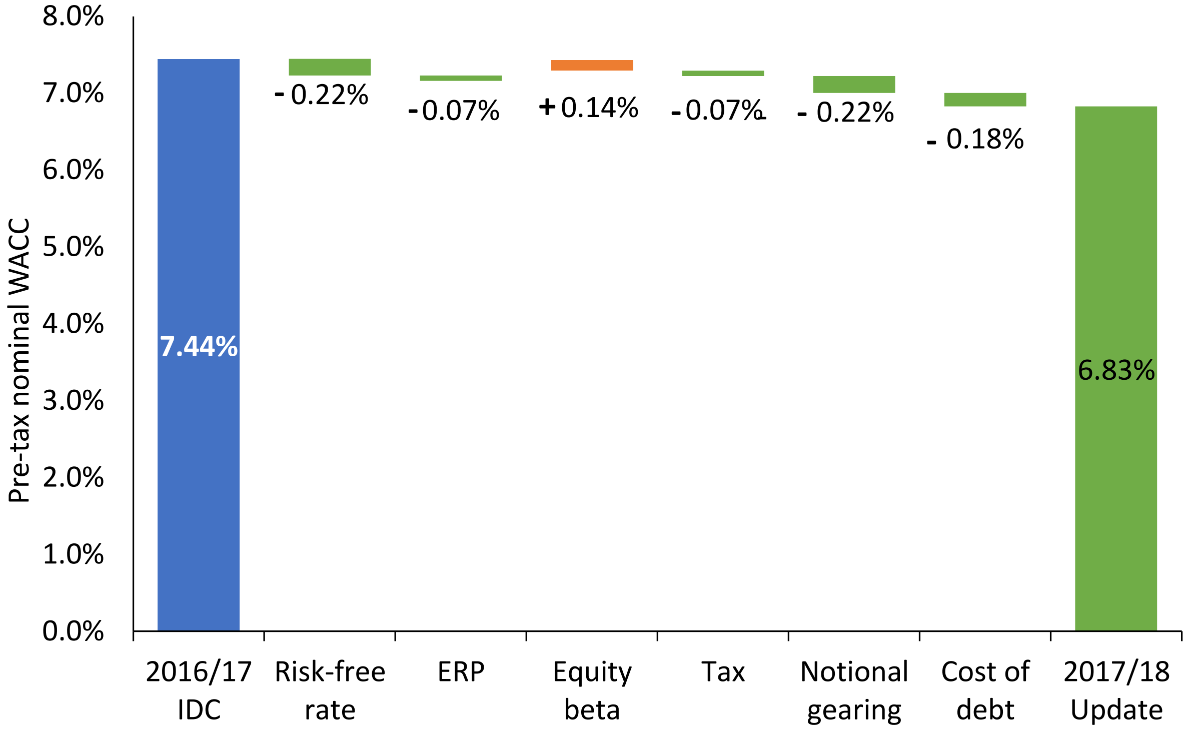
Cost of Debt (nominal): This has decreased by updating the historical trailing average data;

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

Tax Rate: tax rate (19%) reduced following the Chancellor's Autumn Statement.

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

Figure 1: Diagram showing changes to capped IDC for OFTOs as a result of updated input parameters for 2017-18



As the updated input values indicate a current rate materially lower than that decided upon last year, we will update the OFTO cap for the financial year 2017-18 to 6.83%.