

Interconnector developers and  
other interested parties

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Date: 17 July 2017

Dear stakeholders,

### **Decision on the Final Project Assessment of the NSL interconnector**

In October 2016 we consulted on our Final Project Assessment (FPA) of the North Sea Link (NSL) interconnector to Norway.<sup>1</sup> This letter is our final decision on the FPA. We had five responses to our consultation, four of which are published alongside this letter. We have taken these responses into account in reaching our decision.

#### **Background**

The NSL project is a 1.4GW electricity interconnector between the Norwegian and GB transmission systems, jointly developed by National Grid North Sea Link Limited<sup>2</sup> (NGNSL) and Statnett. The project is currently under construction and is expected to enter commercial operation at the start of 2022.

We considered the needs case for the project at our Initial Project Assessment, and decided in March 2015 to grant a cap and floor regime to the project.<sup>3</sup> This was based on our assessment that the project is likely to significantly benefit GB consumers and GB as a whole. Our cap and floor regulatory regime applies to NGNSL's 50% share of the cost and revenues of the project.<sup>4</sup>

In 2016 we undertook our FPA, which was the first formal FPA stage for a cap and floor project. At that stage we assessed the economic and efficient costs for the capital expenditure (capex). We also provided confirmation of the cap and floor regime design as well as the financial parameters that apply to the NSL project.

We consulted on our proposals in October 2016. Our consultation was supported by analysis from Atkins and GHD consultancies.

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<sup>1</sup> Our consultation on the FPA of NSL is available at: <https://www.ofgem.gov.uk/publications-and-updates/final-project-assessment-nsl-interconnector-norway>

<sup>2</sup> National Grid North Sea Link Limited (NGNSL) is a company structured on behalf of National Grid Interconnector Holdings (NGIH) responsible for National Grid's share of the NSL project.

<sup>3</sup> Our decision on the Initial Project Assessment of NSL is available here: <https://www.ofgem.gov.uk/publications-and-updates/decision-initial-project-assessment-nsn-interconnector-norway>

<sup>4</sup> The costs that inform our cap and floor levels are: 100% of NGIH's development costs; 0% of Statnett's development costs; 50% of the total costs of cable, converters, site preparation (in both Blyth and Kvilldal) and trading systems; 100% of GB-specific separate costs; and 0% of Norway-specific separate costs.

## Our decision on the FPA

We have reviewed and considered the consultation responses that we received. We have now confirmed our view on cost allowances and the financial parameters for the project. The provisional cap and floor levels derived using these cost allowances and parameters are £89.85m and £50.90m respectively.<sup>5</sup>

We present the main themes from the responses, and our final views on those elements, below. We have provided a detailed summary of consultation responses in Annex 1.

### Cost assessment and financial parameters

During our review of consultation responses we were made aware that some of the cost information we received for our FPA was not in the price base we requested. We have worked with NGNSL to understand the impact this has on the cap and floor levels. The reduction in the levels presented now, compared with those in our FPA consultation, is primarily as a result of converting the updated costs supplied into real 2015/16 prices.

Our treatment of these costs to derive a total cost figure remains as it did in our FPA consultation. We have:

- Excluded costs that relate to variation orders, options and additional provisions. We will review these costs, if they arise, at the post-construction review (PCR) stage;
- included a placeholder for risk allowance of £59m (this being half the submitted level);<sup>6</sup>
- reduced the 'Other costs' at the FPA stage by £0.63m to account for our view on commissioning power.

We can now confirm our view on NGNSL's eligible costs, set out in Table 1 below. These costs, in 2015/16 prices, have been used to set the provisional cap and floor levels.<sup>7</sup>

Table 1: Our view on the efficient costs at the FPA stage

All values in £m 2015/16		Submitted costs at IPA	Submitted costs at FPA	Our FPA consultation position	Revised submitted costs at FPA	Our final FPA decision on allowance
NSL (developer) costs	Risk/contingency	84	116	58	117	59 <sup>1</sup>
	Project management	59	42	42	43	43
	Other costs		31	30	30	29
Contracts	Firm prices and provisional sums	757	474	474	429	429
	Variation orders, options and additional provisions		34	0	31	0
<b>Total costs</b>		<b>900</b>	<b>697</b>	<b>604</b>	<b>650</b>	<b>560</b>

<sup>1</sup> We have used a 'placeholder' value of £59m for risk and contingency. The outturn value will be assessed and set at PCR stage.

The operational, decommissioning and insurance costs that have been used to set the cap and floor levels are also provisional at this stage. These provisional values will be updated following our assessment at the PCR stage.

<sup>5</sup> Rounded to the second decimal place.

<sup>6</sup> Rounded to the nearest whole number.

<sup>7</sup> The cost base has been updated to ensure that all costs provided are shown in the correct price base.

The financial parameters set out in our consultation also remain fixed. These reflect the policy intent for the first application window of our cap and floor regime, and reflect the market specifics at the point of NSL's investment decision.

Some respondents raised questions around our planned application of interest during construction (IDC) for the project. IDC will be applied mechanistically (based on the rate set at FID) to the efficiently incurred spend profile, as determined at the PCR.

Our policy decision for projects applying for our first cap and floor application window<sup>8</sup> noted that we would only grant IDC associated with project delays if developers can demonstrate they were outside of their control. We can confirm that NSL is currently expected to commission at the start of 2022. This is a delay of a year based on the policy set for projects approved in our first cap and floor application window. We have decided to grant IDC for this one-year delay based on the information provided to us by NSL. This was already applied in the financial model published alongside our FPA consultation, and so has no bearing on the revised cap and floor levels for the project. If NSL is delayed further, we would have to take a separate decision on whether to grant IDC for the period of the additional delay, and would take that decision at the PCR stage.

### *Cap and floor levels*

We can confirm the provisional cap and floor levels of £89.85m and £50.90m. These cap and floor levels are slightly different from those of £94.2m and £53.0m included in our consultation document. We have included a description of changes to these levels in Annex 3.

These cap and floor levels will now be implemented through licence changes which will give effect to the cap and floor regime for NSL. The final cap and floor levels will be confirmed following completion of the PCR stage.

### *Risk eligibility and scope of the PCR*

A number of respondents raised questions about our proposed approach to assessing risk-related expenditure as part of the PCR stage. We have set out further information on the PCR in Annex 2 of this decision. This builds on the information provided in our FPA consultation.

We have confirmed a placeholder value of £59m for risk-related spend. This is a minor update to the value that we included in our consultation, to reflect the impact of inflationary changes on NSL's cost base. This value is indicative; allowed risk-related spend will be determined by the PCR process. However, we have included a placeholder value at this stage to give a reasonable estimate of the final cap and floor levels based on the information currently available.

### *Foreign exchange risk and inflationary risk*

We agree with the hedging strategy taken to date, and expect NSL to continue to hedge where sensible as more costs become firm during construction. We will consider future hedging costs at the appropriate rate based on actions taken by NGNSL. Where they think it is sensible to hedge, we will consider the costs of this (either an option to buy, or buying forward). Where costs are incurred in other currencies and cannot be hedged (for uncertain or unforeseeable items), we will review these at PCR and allow them into the cost base at prevailing exchange rates (based on dates incurred).

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<sup>8</sup> Our August 2014 decision to roll out a cap and floor regime is available at: <https://www.ofgem.gov.uk/publications-and-updates/decision-roll-out-cap-and-floor-regime-near-term-electricity-interconnectors>

For future projects, we expect developers to implement sensible hedging strategies to limit commercial and consumer risk. However, we do not provide a general 'hedging allowance' and recognise that in some situations it will be more sensible and appropriate not to hedge against foreign exchange risk. We expect developers to provide a hedging strategy and associated rationale as part of FPA submissions.

We will fix allowances in 2015/16 prices for items set at the FPA. Where a forecast inflation figure is needed to set the cap and floor levels, we will continue to use the retail price index (RPI), as set out previously in our cap and floor policy decisions. However, these estimates of future inflation will be replaced by actual values at Post Construction Review to adjust cap and floor levels. Equally, reflation from 2015/16 price levels to nominal values for comparison with actual revenues (once the project is operational) will be made using actual RPI outturn values.

### **Next steps**

This decision concludes the FPA stage of our cap and floor assessment framework for the NSL project. We will update NGNSL's interconnector licence in summer 2017 to give effect to this decision.

During the construction period, NSL will report to us on an annual basis in line with the regulatory instructions and guidance (RIGs) process. NSL will need to ensure that these submissions are complete each year. We will then use the information provided to inform our PCR stage, which we expect will take place in 2021. As part of the PCR, we will assess operational expenditure (opex) and any eligible cost variations (see Annex 2).

The other interconnector projects approved as part of our first cap and floor application window will need to submit their applications for our FPA stage once cost information is sufficiently detailed. We recognise that our process may need to be adapted to suit the specific arrangements for individual projects, for example based on the timing of procurement processes and investment decisions. We will continue to work with developers to ensure that our process is suitable for forthcoming projects, and to provide guidance on what we expect as part of the FPA submission.

If you have any questions on the contents of this decision letter, please get in touch with Stuart Borland on 020 7901 7134 or by email at [cap.floor@ofgem.gov.uk](mailto:cap.floor@ofgem.gov.uk).

Yours faithfully,

**Akshay Kaul**

**Partner, Commercial Networks**

## **Annex 1: Summary of consultation responses for the Final Project Assessment of the NSL interconnector**

This annex summarises four public and one confidential responses to the consultation and our clarifications on the issues identified. Repeated issues are treated in the first question that they come up. Respondents included interconnector developers and a transmission system operator (TSO). There were no responses from consumer groups or generators. The non-confidential responses have been published on our website and copies are also available from our library.

### **Question 1: Do you agree with our benchmarking of the NSL project?**

Four respondents agreed broadly with our approach to benchmarking cost. One disagreed with our decision to disallow the cost for commissioning power, and with the condition to demonstrate that all costs were efficiently incurred. Another respondent suggested there are other benchmarks which could be included to better capture the range of cost outcomes without giving information.

*We maintain our decision to disallow the cost of commissioning power because we believe this cost to be a commercial cost that NSL can trade as part of the commissioning process. We do not expect it to sit in the cap and floor. If NSL provides evidence that it cannot trade this out (ie they are unable to trade the power used to commission the link), then we may consider it as an eligible cost at the PCR stage.*

### **Question 2: Do you agree with our views on NSL's level of project management?**

Most respondents did not have any views on this question. One suggested that the project management cost should be fixed in the native currencies of the costs in real 2015/16 terms to account for inflation and currency fluctuations.

*We have fixed the project management costs in the original currency. However, our decision is not to provide a blanket hedging allowance. We expect NSL to continue to hedge where sensible as more costs become firm. Where costs are incurred in other currencies and cannot be reasonably hedged, we will review these at PCR in pound sterling terms. Costs that cannot reasonably be hedged will be allowed at the prevailing exchange rates and based on dates incurred. For the avoidance of doubt, we will only allow changes to project management costs due to currency fluctuations where hedging was not possible.*

### **Question 3: Do you agree with our views on and proposed approach to project risks?**

One respondent stated that the definition of unrelated external parties and contractors were not clear. The respondent also proposed for items not currently hedged to be reviewed at PCR and to allow a blend of real and nominal costs to be fixed at FPA.

*Parties contracting directly with NSL are not considered as "unrelated third parties". Where NSL incurs additional costs in relation to the performance of its contractors, these will not qualify for the PCR unless: causation sits with a third party; and, either the issue giving rise to these costs was not reasonably foreseeable, or it would have been uneconomic to take measures that would have mitigated the full extent of the risk.*

*We will fix allowances in 2015/16 prices for items set at the FPA. Where a forecast inflation figure is needed to set the cap and floor levels, we will continue to use the retail price index (RPI), as set out previously in our cap and floor policy decisions. However, these estimates of future inflation will be replaced by actual values at Post Construction Review to adjust cap and floor levels. Equally, reflation from 2015/16 price levels to nominal values for comparison with actual revenues (once the project is operational) will be made using actual RPI outturn values.*

Two respondents asked for clarity on the principles used for risk sharing between FPA and PCR. Another respondent disagreed with fixing provisional sums at FPA and wanted most variations in provisional sums to be eligible for review at the PCR stage.

*We have included more information on the types of risk that we would see as eligible, considered on case-by-case basis or ineligible for review at the PCR stage in Annex 2 of this decision. This builds on our previous consultation positions. If cost variations are deemed to be eligible for the PCR, and are then assessed to have been efficiently incurred, these costs will be included in the final cap and floor levels.*

*We would expect the outturn level of provisional sums to be in line with that set at the FPA. If the developer can justify any deviations from this level, we will consider this for inclusion through the PCR.*

**Question 4: Do you agree with our proposed approach to the post-construction review (PCR)?**

One respondent stated that the assessment of risk at PCR created ongoing uncertainty that may reduce the financing solutions available to some projects.

*For NSL, we are delivering the FPA and PCR in line with the process set out in our policy framework. In order to provide more certainty to developers we have included a non-exhaustive list of risks that we would see as eligible for PCR in Annex 2. We will engage with NGNSL annually through the RIGs returns so that they are aware of our initial views on issues. This should help to maintain their confidence in the period between FPA and PCR. We will consider the process for other projects as part of the variations process, where requested and justified, at the FPA stage. This should ensure that consumers are not underwriting inefficient costs. We are also open to tailoring our approach for different financing solutions, where needed and justified.*

Two respondents stated that fixing IDC allowance at FPA and reserving the right to allow adjustments at the PCR if capex spend profile changes introduce uncertainty. One suggested that IDC should be based upon the final phased costs at PCR. Another respondent suggested that IDC should be fixed at FPA and only reviewed at PCR for those elements that have been specifically identified at the FPA stage as subject to PCR stage review and other unforeseen events.

*Our decision is that IDC will be applied mechanistically and so will match the actual incurred efficient spend profile. The amount earned on the fixed costs is essentially set now subject to spend being incurred in line with the expected spend profile. IDC will also be earned on any additional costs incurred during this period that are allowed through the PCR. Where projects face delays outside of the developer's reasonable control based on our assessment, we will allow IDC on efficiently incurred costs for the period of the delay.*

Two respondents asked for extra information on PCR eligibility principles and the necessary burden of proof for assessment at the PCR. One respondent proposed that items with the biggest variability risk should be assessed at PCR rather than at FPA. A different respondent suggested that changes in costs that meet the criteria set out in policy are reviewed at PCR otherwise costs are fixed at FPA.

*Our FPA is designed to give certainty to developers around costs. However, we are deferring the assessment of risk-related and uncertain costs until the PCR, as an ex-ante assessment would expose either the developer or consumers to risks they cannot control. We provide more detail on the PCR process and the eligibility criteria in Annex 2.*

Another respondent noted the need to provide for bespoke risk allocation suitable for various financing solutions (eg project financing). The same respondent suggested that project specific circumstances may require insurance cost to be determined at different stages and sought clarification on what would guide such a process.

NSL's FPA reflects our baseline approach for risk allocation. Where developers can clearly demonstrate a need for a variation in approach to risk allocation, we will consider it. The insurance for the construction phase will be assessed alongside capex at our FPA stage, and any variations to this will be subject to the same eligibility criteria as other variations in cost. Insurance for the operational stage will be assessed alongside opex at the PCR.<sup>9</sup>

**Question 5: Do you have any other views on the post-construction review for NSL?**

Respondents want clarity on how options, surveys and variation orders will be reviewed at the PCR.

*We have provided for allowable risk-related and uncertain costs at the FPA and will review any variations at the PCR. If any risk or uncertainty-based spend arises linked to variation orders, surveys and options, NSL will need to evidence that it was appropriate and has been efficiently incurred for it to be considered.*

One respondent disagreed with our position to disallow any within-period assessment (WPA) until the PCR is complete. The respondent asked if a WPA can be triggered within the fifth year.

*On the timing of the PCR – we can clarify that the onus will be on the developers' submissions, to reduce concerns that due to delays in our PCR process the WPA is not accessible.*

*The WPA is available at the end of years 1, 2, 3 and 4; the final revenue assessment then comes at the end of year 5. The mechanism for application and approval of the WPA will be set out in the relevant licence conditions.<sup>10</sup> For the avoidance of doubt, the WPA (ie the payment itself) is only available at the end of the year and cannot be made in advance of the end of the year. This is because any WPA payment has to be made via the usual Transmission Network Use of System (TNUoS) cycle.*

**Question 6: Do you agree with our proposal to set an availability target of 93.0% for the NSL interconnector based on the updated report by GHD consultants?**

One respondent asked the basis for proposing an availability target of 93% rather than using the 92.86% recommended by our technical consultant GHD<sup>11</sup>. Three respondents stated that there is no incentive on NSL to maintain availability if revenues were above the cap. Some suggested a review of the +/- 2% threshold to give incentive beyond 95% and one suggested a continuous review of the target.

*We have decided to keep the availability target of 93% and incentive threshold of +/-2%. This has been established via our cap and floor regime policy and is currently consistent for all projects. We believe that the cap and floor regime has sufficient safeguards in place to manage non-performance risk. We note that developers may request regime variations provided they can demonstrate that these are in the interests of GB consumers – however, in this instance, we do not consider that the benefit to consumers has been sufficiently demonstrated.*

**Question 7: Do you have any views on the updated regime design, financial parameters or cap and floor financial model (CFFM)?**

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<sup>9</sup> We may consider conducting our opex assessment at the FPA stage where the financing approach taken requires it and it has been demonstrated to be in the interest of GB consumers.

<sup>10</sup> The WPA mechanism is included in Special Condition 6 of Nemo Link's interconnector licence, available here: <https://www.ofgem.gov.uk/publications-and-updates/decision-changes-standard-conditions-electricity-interconnector-licence-electricity-interconnector-licences-held-nemo-link-and-nqil-and-electricity-transmission-licence-held-nqet>

<sup>11</sup> [https://www.ofgem.gov.uk/system/files/docs/2016/10/ofgem\\_-\\_availability\\_model\\_update\\_-\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/10/ofgem_-_availability_model_update_-_final.pdf)

All respondents stated that in general the proposals agreed with the principles of the cap and floor regime. One respondent asked how a change in the length of the regime and the associated financial years would affect the cap and floor levels. The respondent proposed aligning financial year basis of CFFM with the reporting year of the project.

*Following consideration of responses, we will move to align the cap and floor assessment periods with the financial year reporting cycle for the RIGs. This change is reflected in the updated CFFM published alongside this decision. We note that basing the assessment periods with financial years may not be optimal for interactions with the TNUOS charging cycle, and we may adopt different approaches where justified on a project-specific basis.*

*In line with our policy decision on the cap and floor regime, NSL may lose some of the duration of its regime if the project is not operational on the planned regime start date. This will reduce the final 5-year assessment period by the length of the delay between 1 January 2021 and the date of commencement of commercial operations. The cap and floor levels will continue to be set as if the regime applies for the full 25-year period and these will therefore be the same as they would have been otherwise (ie if the project were to connect on time). However, we will allow a 'pause' for any force majeure events. Delays caused by such events will not reduce the length of the regime.*

Another respondent suggested adjustment to the default regime and FPA process in order to attract project finance funding.

*NSL's FPA represents our baseline process for FPA. However, where developers demonstrate a need for a variation in regime, we will consider such requests on a case-by-case basis. We published an open letter in December 2015 which set out how this process may help to facilitate project finance, and we would encourage interested developers or market participants to get in touch with us if further discussion would be helpful.<sup>12</sup>*

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<sup>12</sup> Our December 2015 letter on interconnector financing is available at: <https://www.ofgem.gov.uk/publications-and-updates/enabling-range-financing-solutions-under-cap-and-floor-regime>

## **Annex 2: Further information on our approach to evaluation at the PCR stage**

### **Our position for consultation**

In our October 2016 consultation on NSL's FPA, we set out our principles for cost eligibility and evaluation at the post-construction review (PCR) stage. We gave some specific items that may be considered, such as extreme weather; a change in consenting requirements/procedures that could not have been reasonably expected; and ground condition changes from those shown in surveys which were conducted in line with good industry practice.

Consultation responses highlighted that further information on how we will apply these principles, and on the sorts of risks that may be within and beyond scope of the PCR, would be helpful. This annex aims to provide additional information to NGNSL and to other interconnector developers.

Generally, we note that there are a number of synergies between our PCR stage for cap and floor interconnectors and our final transfer value cost assessment for offshore transmission owners (OFTOs). In both instances, we are looking to determine the economic and efficient costs that ought to have been incurred in developing and constructing the relevant transmission assets. In assessing risk-related expenditure at PCR stage we would expect to follow similar principles as under the existing cost assessment framework for OFTOs, which is well-established<sup>13</sup>.

Our approach for the interconnector PCR process broadly consists of two elements: (1) principles for eligibility; and then (2) assessment of eligible risks.

### **Principles for eligibility**

In our FPA consultation we noted that at the PCR stage we will review costs which:

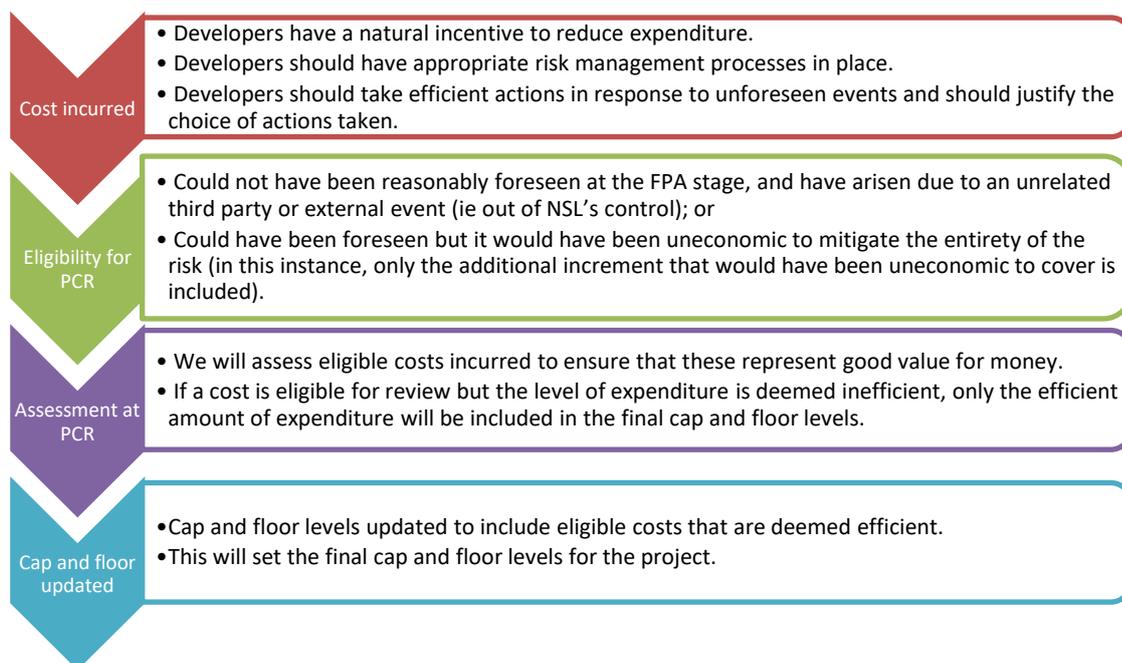
- Could not have been reasonably foreseen at the FPA stage; and
- Have arisen due to an unrelated third party or external event (ie out of NSL's or its direct contractors' control).

After considering consultation responses we have also decided to allow for risk-related expenditure where the risk is foreseeable but it would have been uneconomic to mitigate the entirety of it. We present the final eligibility criteria in the diagram below.

Items that are deemed eligible will be reviewed for their economic efficiency before the costs are accepted and therefore included in the cap and floor levels.

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<sup>13</sup> See our guidance document at: <https://www.ofgem.gov.uk/publications-and-updates/offshore-transmission-guidance-cost-assessment>



## Examples of eligible risks

We recognise that interconnector projects are large, complex assets and that they often face unique construction risks on a case-by-case basis. This is why we have not sought to include a definitive list of risks that will or will not be eligible for assessment at the PCR stage. Not all projects will face the same risks, and some projects may encounter risk-related expenditure that neither the project developers nor we could have foreseen. However, a number of respondents to our FPA consultation suggested that more information around the types of risk that we would see as eligible for PCR assessment would be helpful.

The section below lists some specific risks where we would expect related expenditure to be eligible, considered on case-by-case basis for eligibility or ineligible for assessment at the PCR stage. These lists are non-exhaustive and it will be the responsibility of project developers to demonstrate that risk-related expenditure meets our eligibility principles in the PCR submission.

### ***a. Examples of risks that we would expect to be eligible for our PCR assessment:***

- Weather conditions (cable) – harsh weather conditions offshore beyond statistical expectations for that time of year.
- Soil conditions are significantly different to those indicated by the survey<sup>14</sup>, and therefore additional rock placement or ploughing/burial equipment is required.
- Damage is caused to the cable by a third party during installation, which could not have been reasonably protected against (i.e. is not due to negligence on the part of developer or contractor).

<sup>14</sup> Assuming that the initial survey was conducted in line with industry good practice and therefore should have been deemed reliable. We will not be taking a view on the quality of surveys and therefore the onus is on project developers to ensure these are appropriate. We would expect the developer to have negotiated suitable rates in advance such that they are not a distressed buyer of services.

- TSOs at either end change the connection arrangements or requirements, which leads to new design requirements and/or delays.
- Grid reinforcement works by TSOs are delayed.
- Weather conditions (converter) – site conditions mean that construction is delayed beyond what could have reasonably been expected. This can cover excessive wind, flooding, snow, avalanche etc.
- Unexploded ordinance not detected by adequate surveys result in additional costs<sup>15</sup>.
- Additional remediation costs due to changes in legislation.

***b. Examples of risks that we would consider on case-by-case basis for eligibility under the PCR assessment:***

- Contractors or other related parties fail to deliver on their contracted expectations or obligations.
- Knock-on effects from contractor delivery of other major projects cause delays/additional costs.

For both of the above examples to be considered for inclusion in the PCR, we would expect the following circumstances to apply:

- The additional incurred costs are in excess of contractual penalties
- The developer had adequate risk monitoring processes in place and took timely action to mitigate incurred cost
- It would have been uneconomic to insure against the scale of the contractor failure.

***c. Examples of risks that we would expect to be ineligible for our PCR assessment:***

- Performance of the project organisation leads to delays or additional costs.
- The cable or converter design is unsatisfactory, leading to additional costs or delays.
- Cable or converters are damaged during transport (unless this is due to third party actions or weather events beyond usual expectations).
- Cable laying vessels break down or are not available as scheduled.
- Cable is damaged during manufacturing.
- Cable damage during installation due to inappropriate practices/use of inappropriate equipment.

**Our PCR assessment of eligible risks**

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<sup>15</sup> Assuming that the initial survey was conducted in line with industry good practice and therefore should have been deemed reliable. We will not be taking a view on the quality of surveys and therefore the onus is on project developers to ensure these are appropriate. We would expect the developer to have negotiated suitable rates in advance such that they are not a distressed buyer of services.

We recognise that there is a strong incentive on developers to efficiently manage and minimise costs within the construction phase, and that this incentive extends to unexpected costs. However, we still think it is necessary to assess the costs incurred in dealing with unexpected events. This is to ensure that the costs have been efficiently incurred, and represent good value for consumers. Where costs are well-evidenced and considered then we would allow these into the project cost base, and the cap and floor levels would be adjusted accordingly.

In the PCR submission, developers will need to provide robust evidence that costs incurred in relation to risk events (both for mitigation of anticipated risks and for response to risks that materialise) are efficient. The evidence will need to demonstrate that these costs were well-considered, justified and were good value for money. We will look to ensure that proper process was undertaken, that risk-related expenditure is well-documented, and that costs incurred were not excessive for that type of action.

In addition, our dialogue with project developers throughout the construction stage as part of our annual RIGs reporting process should provide developers with an opportunity to ensure that costs (including in relation to risk events) are updated regularly and that sufficient supporting evidence is provided to us. Whilst we will not assess any cost variations (including risk-related expenditure) prior to the PCR stage, we expect developers to provide us with justification as the project progresses. If we notice large variances from the planned expenditure, we may ask for further evidence during this annual process. We would also ask for further evidence and justification if the PCR submission differs from the iterative updates received as part of the RIGs reporting process.

### **Annex 3: Changes to the cap and floor levels**

In this decision we have confirmed provisional cap and floor levels of £89.85m and £50.90m. These represent a slight change from the levels of £94.2m and £53.0m in the consultation document. This annex includes the reasons for these changes.

The changes that impact the cap and floor levels are:

- Cost price base and inflationary effects.
- Timing and scale of financial transaction costs within the cap and floor financial model.
- Correction of the calculation of transaction costs associated with raising the finance for the project.
- Replacing a macro to calculate the tax implications of interest payments with an algebraic solution.

The provisional costs of the project have been confirmed as the same as in our consultation document. This means that the actual cost values are not a driver of the change in cap and floor levels.

#### *Cost price base and inflationary effects*

As part of the consultation we were notified by NSL that some of the initially assessed costs had not been submitted in the common 2015/16 price base that we used throughout our FPA. This had led to a difference in the cost base between cost items, and therefore to slightly different cap and floor levels than would otherwise have been the case.

We have changed the relevant cost values, and updated the spend profile in the model, to ensure these are in 2015/16 prices and consistent with our assessment throughout the FPA as a whole. This has decreased the cap and floor values.

#### *Timing and scale of financial transaction costs*

Following our consideration of consultation responses, we have updated the cap and floor financial model to align the incurring of financial transaction costs with the start of the construction period, rather than the start of operations. We agree that this better represents the stage at which these costs are likely to be incurred, and this change will be included in the default cap and floor financial models for all future projects at the FPA stage.

The allowances for financial transaction costs are designed to be common across projects, and to be notional – we don't try to mirror the actual costs incurred for projects. As such, we have also limited the scale of the financial cost allowance to ensure that this affects 100% of the efficient cost base, but not more. We have maintained the allowances of 2.5% for debt transaction costs and 5% for equity transaction costs as set out in our cap and floor regime policy.

#### *Correction of a formula*

We have made a housekeeping change to the CFFM in order to replace a macro to calculate the tax implications of interest payments with an algebraic solution. This ensures consistency with our default modelling approach. The impact is a small decrease in the cap and floor levels.