SCOTTISHPOWER

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IDC Review
Ofgem
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Dear Kate,

Review of the methodology for the calculation of the Interest During Construction for Offshore Transmission and future Interconnectors granted Cap & Floor

Thank you for the opportunity to respond to this consultation. Our responses to the consultation questions are in Annex 1 to this letter, which contains some general points.

Ofgem is proposing to adopt a common framework and methodology for setting interest during construction (IDC) for offshore transmission, for interconnectors granted cap and floor support, and for the cost of capital that could be applied to the Competitive Proxy Regime for onshore transmission. The proposed approach to setting the IDC, and the linking of the regulatory regimes in this way, is entirely new.

If Ofgem wishes to take decisions linked in this way in such a significant area, it needs to hear from all affected stakeholders and to consider all their input before deciding. We believe Ofgem should have extended the consultation response deadline to 20 March to align that with the consultation on the proposed delivery model for Hinkley Seabank[1] (HSB) so that it could consider issues raised by all stakeholders in the round.

We are also concerned that Ofgem is seeking to make radical change based on a new model, without calibrating that model against other models and seeking to understand the differences. Disaggregating the investment cycle into a build phase and an operation phase may be a helpful tool, but if the calculation is done correctly, the aggregate return should broadly equate to that found using conventional indicators. There is no indication that this cross check has been done, and our suspicion is that reverse calculating the build phase cost of capital from market indications of lifetime returns on projects, and the operational phase cost of capital revealed in OFTO auctions, would give much higher figures.

We have also had some difficulty reproducing Ofgem's calculations in the Capital Asset Pricing Model. We believe some of the issue relates to the exclusion of tax effects but would be grateful for more working to be shown in future publications in this area.

[1] https://www.ofgem.gov.uk/system/files/docs/2018/01/hsb_condoc_delivery_model.pdf

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Grandfathering of existing CfD agreements

The proposed changes to the methodology for setting the OFTO IDC could amount to an unfair retrospective change for projects which have already been awarded CfD but are not grandfathered by virtue of having reached FID by 31 March 2018. Developers will have based their CfD bids on their expectation of the future IDC rate, which they would reasonably assume would be based on the IDC methodology previously adopted by Ofgem. We think it would be unreasonable to change the methodology for projects which have already received a CfD.

Proposed methodology and approach

The general approach and rationale set out by CEPA in its report[2] relies on a number of key judgements about the relative risks of different activities which we believe require further substantiation, given that they are used to support a reduction in the proposed IDC for OFTOs from 6.85% (on the current methodology) to 5.96%.

The most significant issue is the one of risk. Apart from an assertion that the basket of construction and engineering companies represents an upper bound on the equity beta, the documents do not justify why these companies are higher risk than the various sectors Ofgem is seeking to apply the methodology to. Indeed, there are good reasons to take the contrary view:

- Construction companies will typically work on a number of projects, thus diversifying the risk; the projects being considered by Ofgem are generally one-offs not readily diversified by the ultimate investors.

- A construction company can offset risk by building in a contingency, passing on costs to the client (if the contract allows) or charging for variations. In the OFTO case, only the first option is available (when formulating the CFD bid) and in the networks competition proxy case, Ofgem will closely monitor any contingencies, variations and cost over-runs, and can disallow them. In general, we think a construction company is more likely to be able to recover cost over-runs, not less.

In Annex B CEPA sets out an assessment of the relative risks of the competitive onshore, developer self-build OFTO and interconnector regimes. This analysis is pivotal as it underpins CEPA's determination of asset and equity betas that are a key component of the calculation of the IDC. However, no detailed analysis for construction companies is presented (for example as a fourth column of the table). Furthermore, the relative assessment between competitive proxy, OFTOs and interconnector in Annex B.2 does not support CEPA's differentiation of risk profiles between the three regimes, notably on the assessments of capex and development risks.

We would identify the following additional issues with the approach detailed in CEPA's report:

- Construction timescales: In the section on yield to maturity (para 6.1.2) CEPA state "...our understanding [is] that a typical OFTO project would have a construction period towards the shorter end of the spectrum, around 1-3 years." This 1-3 year horizon seems to inform CEPA's choice of debt tenors and equity price curves with respect to offshore transmission. We would argue that a significantly longer timescale is more appropriate in order to take account of the development as well as the construction period, which will require to be financed prior to the transfer of the

[2] https://www.ofgem.gov.uk/system/files/docs/2018/01/cepareport_newassets_23jan2018_0.pdf

transmission asset to the OFTO. It is also unreasonable to stop IDC at first export (on the grounds that it is now earning money) as it is likely to be a significant further time before the cable is fully utilised by the wind farm. Selecting a longer timescale would push up the level of risk for offshore transmission beyond CEPA's assumption and this should be reflected in longer time horizons being considered by CEPA on debt and equity.

- Mid-range point estimates: CEPA use mid-point estimates for a number of components of the IDC calculation and then for the final nominal IDC range. We consider that some of the component ranges are somewhat questionable, for example gearing. In our view, this approach risks setting an IDC that is below the level of a reasonable rate of return companies would expect to realise from offshore transmission construction. We would observe that there is asymmetric risk in setting prices (with insufficient returns likely to be more damaging than slightly over-generous ones) and that other regulators have mitigated this risk by selecting upper quartile point estimates rather than the mid-point[3]. We would suggest Ofgem also adopt this approach.

Should you have any questions in relation to this response, please do not hesitate to contact me or Joseph Dunn.

Yours sincerely,

Rupert Steele

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Director of Regulation

[3] https://www.oxera.com/Latest-Thinking/Agenda/2015/Aiming-high-in-setting-the-WACC-framework-or-guess.aspx

Annex 1

REVIEW OF THE METHODOLOGY FOR THE CALCULATION OF INTEREST DURING CONSTRUCTION FOR OFFSHORE TRANSMISSION AND FUTURE INTERCONNECTORS GRANTED THE CAP & FLOOR REGIME

SCOTTISHPOWER RESPONSE

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

Aligning the approaches is only desirable if the aligned methodology makes sense in each application. It would help nobody to set an inappropriate cost of capital for a sector on the basis that the methodology had been used elsewhere. So while a common approach may well be desirable in principle, the question of whether it is right in practice in each application needs to be asked and answered.

If Ofgem decides to use a common framework for determining IDC and construction cost of capital for onshore transmission in the competition proxy model, there is a risk that in determining the IDC ahead of the cost of capital for Hinkley Seabank (HSB), Ofgem could constrain its ability to respond to stakeholder feedback on the HSB consultation. We would therefore recommend that Ofgem delays its decisions on the IDC until it has received and considered a full range of stakeholder feedback on both consultations.

Specifically on the matter of IDC, we do not consider CEPA's approach as set out in their report provides sufficient justification to support a differentiation of risk and the resultant costs of capital between the three regulatory regimes.

Finally, we agree with Ofgem that the methodology for setting the IDC should not have any read-across to other regulatory contexts such as RIIO.

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

We are concerned that Ofgem is seeking to make radical change based on a new model, without calibrating that model against other models and seeking to understand the differences. Disaggregating the investment cycle into a build phase and an operation phase may be a helpful tool, but if the calculation is done correctly, the aggregate return should broadly equate to that found using conventional indicators. There is no indication that this cross check has been done, and our suspicion is that reverse calculating the build phase cost of capital from market indications of lifetime returns on projects, and the operational phase cost of capital revealed in OFTO auctions, would give much higher figures.

In the limited time to respond to this consultation we have not been able to scrutinise CEPA's methodology and analysis in detail, but we would offer the following preliminary observations on CEPA's report. We may revisit these issues in more detail in later consultation responses.

<u>Equity Risk Premium</u>

Apart from an assertion that the basket of construction and engineering companies represents an upper bound on the equity beta, the documents do not justify why these

companies are higher risk than the various sectors Ofgem is seeking to apply the methodology to. Indeed, there are good reasons to take the contrary view:

- Construction companies will typically work on a number of projects, thus diversifying the risk; the projects being considered by Ofgem are generally one-offs not readily diversified by the ultimate investors.

- A construction company can offset risk by building in a contingency, passing on costs to the client (if the contract allows) or charging for variations. In the OFTO case, only the first option is available (when formulating the CFD bid) and in the networks competition proxy case, Ofgem will closely monitor any contingencies, variations and cost over-runs, and can disallow them. In general, we think a construction company is more likely to be able to recover cost over-runs, not less.

In Annex B CEPA sets out an assessment of the relative risks of the competitive onshore, developer self-build OFTO and interconnector regimes. This analysis is pivotal as it underpins CEPA's determination of asset and equity betas that are a key component of the calculation of the IDC. However, no detailed analysis for construction companies is presented (for example as a fourth column of the table). Furthermore, the relative assessment between competitive proxy, OFTOs and interconnector in Annex B.2 does not support CEPA's differentiation of risk profiles between the three regimes, notably on the assessments of capex and development risks.

Finally the evidence for the bottom of the asset beta range starting at below 0.5 appears tenuous, based in part on two observed data points in recent years (which could be outliers) and an arbitrary linkage by CEPA to the Scottish TOs.

While we agree in principle with the inclusion of a premium for marine construction risk, there is no evidence provided as to whether this aligns with actual experience.

Cost of Debt

Our main concern is the assumed 1-3 year construction timescale on which CEPA has based its selection of debt tenors for the offshore transmission IDC. In our experience (see table below) the overall duration of development and construction of offshore transmission assets can be significantly longer than this.

	West of Duddon Sands (WODS)	**East Anglia One (EA1)**
Nature	Renewables Obligation project	*CfD awarded Feb 2015* *FID met 31 Mach 2016*
Lease	Awarded December 2003 as part of the Round 2 development programme	Awarded January 2010 as part of the Round 3 development programme
Planning	Application 2006 Granted 2008	Application 2012 Granted 2014
Construction commenced	2012	2017
First Export	January 2014	Expected 2019
Final Export	December 2014	Expected 2021
Complete *(assumes post commissioning work, testing, etc)*	2015	Expected 2021

Based on the above, a longer time horizon of up to 10 years would apply for some of the early tranches of capital, with the volume of capital employed growing as the project progresses through design, preparation and securing of CfDs and consent, physical assets and their testing and commissioning. With this in mind we believe CEPA should consider including debt with tenors up to 10 years and using debt rate trailing averages in excess of one year.

Risk Free Rate

Based on our assessment of an up to 10 year time horizon for financing of offshore transmission projects, we believe CEPA should extend the tenors of gilts and gilt rate averages in line with debt, as described above.

Gearing

While CEPA's proposed gearing of 37.5% is in line with previous Ofgem IDC determinations, we believe it is well in excess of what offshore developers are able to achieve during construction. The underpinning for the CEPA range also appears questionable, with construction and engineering comparators used to justify the low end (at 10%), while the top end of the range is pegged to unspecified PPP projects and media reports of gearing aspirations by National Grid for two of its interconnectors.

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

CEPA use mid-point estimates for a number of components of the IDC calculation and then for the final nominal IDC range. We consider that some of the component ranges are somewhat questionable, for example gearing (see above). In our view, this approach risks setting an IDC that is below the level of a reasonable rate of return that companies would expect to realise from offshore transmission construction. We would observe that there is asymmetric risk in setting prices (with insufficient returns likely to be more damaging than slightly over-generous ones) and that other regulators have mitigated this risk by selecting upper quartile point estimates rather than the mid-point, and as Oxera has pointed out, there are sound economic reasons for doing so[4]. We would suggest Ofgem also adopt this approach.

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

As outlined above, there are risks if Ofgem finalises its decisions on the IDCs ahead of other regulatory contexts where the same underlying methodology and approach will be applied. It is important that a premature decision on IDCs does not constrain Ofgem's determinations in other contexts.

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[4] https://www.oxera.com/Latest-Thinking/Agenda/2015/Aiming-high-in-setting-the-WACC-framework-or-guess.aspx