



Kate Kendall  
Commercial  
Ofgem  
9 Milbank  
London  
SW1P 3GE

Head Office  
Inveralmond House  
200 Dunkeld Road  
Perth  
PH1 3AQ

[Polina.Kharchenko@sse.com](mailto:Polina.Kharchenko@sse.com)

**20 February 2018**

Dear Kate

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

We welcome the opportunity to respond to Ofgem's review of the methodology for the calculation of the Interest During Construction (IDC).

We note that the analysis underlying this consultation constitutes part of a wider analysis that Cambridge Economic Policy Associates CEPA is providing to Ofgem on unifying the framework Ofgem use to set the cost of capital across offshore, Interconnector and new, separable, and high-value onshore transmission projects, which include the Hinkley Seabank (HSB) connection.

As part of the wider consultation on Competition in Onshore Transmission, we are reviewing the CEPA report and related evidence presented by Ofgem. As such, at this stage, we do not believe any conclusions can be drawn on the appropriate cost of capital methodology, in particular the cost of equity, for onshore transmission assets. In relation to the cost of debt, which comprises a large proportion of the cost of capital, we believe significant further work is required to ensure that any investment remains fully financeable and that Ofgem's statutory obligations in this regard are tested on any individual proposal.

We are supportive of a fair and representative cost of capital being used but any conclusion drawn at this stage in relation to onshore transmission assets would be premature and must be considered against wider evidence being presented for RIIO-2. As such, we advocate for a more fundamental review of these parameters as part of a broader debate of the evidence throughout the forthcoming RIIO-2 framework consultation and sector specific consultation periods instead of relying upon one single component of evidence to draw conclusions on



the appropriate methodology for the cost of debt, equity, gearing and any other components of the cost of capital methodology.

We have elected not to comment on the asset life period but will include a comprehensive response as part of our response to the wider CEPA report and Ofgem consultation on extending competition in Onshore Transmission.

Our responses to the questions within the consultation document, in relation to offshore transmission are outlined below.

Kind regards

Polina Kharchenko

Regulation Manager

## Consultation Questions

### Q2. Do you agree with the alternative methodology proposed by CEPA?

- Cost of debt and Risk Free Rate:
  - A tenor of less than 10 years does not appear unreasonable but the duration of construction periods vary across projects. As projects become larger the construction periods, including for transmission assets may be longer than for past projects. This would particularly be the case if the projects involve the construction of assets which will come online in phases across multiple years, but all reach financial close (and therefore fix the cost of debt) at the same date. This should be reflected in any revised benchmarks used.
  - In addition, the tenor of any debt arranged to construct the transmission assets will be significantly longer than the expected construction period. Therefore the financing will need to be committed and available through to the latest possible date for completion of the assets, taking account of all possible delays while still remaining within the final window for the generator to receive its CfD. This is likely to be approximately 3 years longer than the expected construction duration. Furthermore, the pricing achieved on any debt will also reflect the regulated 18 month period between the transmission system being up and running and completion of OFTO transfer.
  - The cost of debt should take account of all of the above tenor-related considerations.
  - The construction of the transmission assets for an offshore windfarm is not similar to general infrastructure, not least due to the significant offshore element and the significant electrical element. Any indices used should reflect the nature of the works, if such indices exist. If such indices do not exist there does not seem to be a strong argument for using an index within the calculations.
  
- Total market return:
  - Forward-looking measures are forecasts only; they are not proven. It would seem more appropriate for Ofgem to base its calculations on proven facts (i.e., historic data) rather than forward-looking measures. In addition the forward looking predictions are also not necessarily reflective of the returns that are acceptable to actual investors making the actual investment decisions; this can only be evidenced by the actual decisions made and returns achieved.
  - UK focus: a large number of the investors in the construction of the transmission assets are international investors. A focus on UK returns only does not appear appropriate when the investors and funders are operating in an international market. A focus on Organisation for Economic Co-operation and Development (OECD) jurisdictions would appear more appropriate.
  
- Equity beta:

- It is entirely reasonable to seek to use the most applicable comparators for the calculation. While we agree that the activity being financed is construction, for which an overall utility comparator may not be wholly applicable, the construction of the transmission assets for an offshore windfarm is a very specific construction activity. Most notably the offshore element to the works presents significant risks not applicable to onshore construction works; further the significant electrical element to the works has a different risk profile from more typical infrastructure construction works. The appropriate comparators require careful consideration as does the uplift for the specific risks, particularly the marine risks.

**Q3. Do you agree with our minded to position to use the mid-point in the ranges produced by CEPA for OFTO's and ICs?**

- The CEPA ranges are very wide. By setting the cap at the mid-point parties who are towards the upper end of the range, but still within the acceptable range (as calculated by CEPA's analysis), will incur significant losses on IDC. If the ranges were narrower, setting the cap at the midpoint would result in less severe losses for generators who are within the acceptable range. The rate set by Ofgem is a cap, not a guaranteed rate at which generators will be reimbursed. We would therefore suggest that the cap is set closer to the upper end of the range and that Ofgem continues to assess the actual rate applicable to each generator in the same way as it currently does.