

Stuart Borland
10 South Colonnade
Canary Wharf
London
E14 4PU

28th November 2019

Dear Stuart,

Consultation on proposed changes to the electricity interconnector Cap & Floor regime to enable project finance solutions (the “Consultation”)

Thank you for the opportunity to participate in this Consultation and provide comments on the proposed changes to the Cap & Floor regime.

As you are aware, GridLink Interconnector Limited (“GridLink”) is a new 1400MW electricity interconnector between the United Kingdom and France. GridLink was awarded status as a Project of Common Interest in 2018 and following an Initial Project Assessment decision by Ofgem in January 2018 (Window 2) has been granted a Cap & Floor scheme in principle.

GridLink is interested in the Consultation as a private developer of an interconnector project under the Cap & Floor scheme whose capital cost will be funded at financial close with a combination of equity and third party debt under a traditional non-recourse project finance structure. Variations to the Cap & Floor scheme which enable project finance solutions are therefore critical to the viability of the GridLink project in a similar manner to the projects which are the subject of the Consultation, namely GreenLink and NeuConnect.

We set out our responses to the Consultation questions below. We also note that while we provided an indication of the scheme variations we would be seeking in our IPA submission in 2016, we will be making our own formal requests for variations to the Cap & Floor scheme, in accordance with Ofgem’s open letter of December 2015 which we expect to submit to Ofgem in the first half of 2020. Accordingly, the responses provided below are based on our experience and our preliminary engagement only with potential project finance lenders with whom we, through our shareholder iCON Infrastructure, have strong relationships and a strong track record of project financing infrastructure assets.

As set out further below, we would be happy to engage further with Ofgem on our responses to ensure that any variations to the regime genuinely enable project finance solutions while retaining a fair allocation of risk between developers and consumers.

This letter and the responses contained in it are not confidential.

I. Overview of regime variations

Question 1: Do you have any views on the project finance variations requested by developers?

The variations (both key and additional) requested by GreenLink and NeuConnect are in line with our view of the key issues that need to be addressed for financiers to consider offering project finance solutions to projects under the Cap & Floor scheme. As we will be making our own formal submission for specific variations to our Cap & Floor scheme in due course, we cannot comment at this stage whether the requested variations (key and additional) are the only variations which would be necessary or desirable to enable project financing or which are ultimately in the interests of UK consumers but we believe the issues raised in the Consultation do need to be addressed by Ofgem.

We note the Consultation focuses on specific variations to the standard Cap & Floor scheme and not directly on the role of Ofgem or the broader FPA process itself. We consider these issues to be



additional factors relevant to this Consultation (and acknowledge that the former is raised by Ofgem in the Consultation).

The role of Ofgem is referenced in the context of its potential role in providing oversight of a competitive and efficient financing process. As you will see from our response in the context of proposed Variation 4, we agree with this concept and believe that processes can be easily implemented to provide comfort to Ofgem that a developer has conducted a competitive and transparent financing process to establish a competitive actual cost of debt, without undue administrative burden on Ofgem.

In addition, we believe the FPA process itself should be reviewed and reconsidered, either generally or specifically for projects seeking project finance. We believe this would help developers to manage the workstreams required to secure project financing and could be structured in a manner which allows Ofgem sufficient time to review and assess FPA submissions appropriately. It is not currently feasible for a developer to submit all information necessary for the FPA submission to Ofgem without meaningful engagement with project finance lenders. However, meaningful engagement with project finance lenders requires a sound indication of Cap & Floor levels for a relevant project. Assuming that establishing the actual cost of debt is relevant to an assessment of the floor level, we accept that it is also very difficult for Ofgem to engage on Cap & Floor levels until a project company can provide accurate information on its expected actual cost of debt.

The process is inherently iterative and thus in our view the FPA process must reflect this reality, or otherwise accept inaccuracy and inefficiency, both likely to be at the expense of UK consumers. Our view is that this practical issue may be one reason that a benchmark approach to cost of debt is preferred by Ofgem because it removes the FPA process from the reality of the project financing process, which by its nature is not final until all commercial, financial and technical elements of the project are settled. We therefore recommend an appropriately staged approach to Ofgem's FPA assessment together with the application of a clear process through which developers can demonstrate to Ofgem that a competitive and transparent financing process has been conducted. Together, these changes will enable developers to properly engage with lenders to secure best possible financing terms while respecting the FPA process, to the ultimate benefit of UK consumers.

Our views on the specific variations proposed are set out in more detail below. As mentioned above, we intend to submit a formal application detailing our own variation requests in the first half of 2020.

Question 2: Do you agree with our categorisation of key and additional variations? Are there any additional factors we should consider?

We agree that the five main variations requested in Table 2 of the Consultation are properly characterized as key issues. We believe that some but not all of the "additional variations" identified in Table 3 and Table 4 should also be characterized as key issues, specifically:

1. The treatment of non-controllable costs;
2. The PCR process;
3. Exchange rate fluctuations; and
4. NETSO payments.

We provide comments on these "additional variations" as follows:

Non-controllable costs

The Cap & Floor scheme provides for some operating costs to be non-controllable and may be passed through in tariffs. These non-controllable costs are defined as:

- The Crown Estate lease fees or property rates and property taxes;
- License fees; and
- Network rates.

In some areas of the UK the Crown Estate is not the owner of the seabed, and ownership is instead vested to a statutory undertaking. Such undertakings are empowered to charge for the use of the sea bed. In such circumstances we believe that charges levied by a statutory undertaking ought to be

treated in the same way as charges levied by the Crown Estate and should thus be deemed to be non-controllable.

Further, some costs such as corporation tax are assumed and fixed at the FPA stage for the duration of the scheme. Material changes in tax rates, which in the current political climate is foreseeable, could significantly impact the economics of a project. We therefore recommend that corporation tax should also be categorised as a non-controllable cost.

PCR process

From our discussions with the lending community, we have received a strong message that any material uncertainty over the nature or amounts of the costs to be recognized by Ofgem after the PCR process may introduce some important headroom into the financial structure and be accompanied by higher credit margins. We would thus urge Ofgem to clarify the PCR process as much as possible and recommend that the scope of Ofgem's review at the PCR stage is limited as far as possible.

Exchange Rates

Exchange rates are fixed at the FPA stage, however financial close will take place after the FPA decision. In the interim period exchange rates may fluctuate. We therefore recommend that exchange rates are fixed at the date of financial close rather than on the date of the FPA decision.

NETSO payments

We understand that, under the current rules regulating NETSO payments, the actual payment of potential top-up amounts from NETSO in case the project company's revenue fall below the floor in a given assessment period may be received up to 2 years after the end of the relevant assessment period. Consequently, Ofgem's minded to position on Variation 1 will not have the intended consequence as lenders will not value an annual assessment in the way that Ofgem might expect, and lenders will certainly require non-efficient capital reserves to be put in place to bridge any additional period (and they will request an amount to satisfy the maximum possible delay period). We therefore look forward to how Ofgem intends to manage an annual revenue assessment (as per the minded-to position on Variation 1) with the time of actual payments by NETSO to projects.

Question 3: Is there additional evidence that we should take into account when considering the implications for consumers and developers of either granting or rejecting the key variation requests?

The provisions of the Cap & Floor scheme will have a significant impact on the terms and conditions upon which lenders will make financing available to a project and ultimately on the attractiveness of the investment for equity. Both factors have a bearing on the overall probability of the project proceeding. Conditions in the scheme which increase overall risk or allocate risk in a manner perceived to be inappropriate will result in two possible outcomes from project finance lenders: (i) no credit available as issues are too binary/risky for lenders, (ii) credit available but at a high cost and/or on the basis of a very conservative financial structure.

The impact of (i) is fatal to the development of private interconnectors. The impact of (ii) is potentially fatal to the development of private interconnectors but if not fatal, then certainly to the detriment of UK consumers as higher costs will ultimately be passed onto consumers through higher tariffs. That is not in consumers' interests nor is it in the interests of interconnector owners. We therefore welcome the opportunity to comment on the points raised in the Consultation and believe that changes can be made to the default regime which provide the certainty which project financiers will require, provide the alignment and incentive which developers and owners require, and fairly balance the risks in inherent in complex and large scale infrastructure projects between consumers and developers.

II. Ofgem's assessment framework and Impact Assessment

Question 4: Is our approach to assessing the costs, risks and benefits of project finance variations suitable? Are there any additional factors that we should build into our assessment?

We note that historically, almost all the electricity interconnectors built in Great Britain have been developed and constructed by the UK TSO (in partnership with overseas TSOs) on balance sheet or with corporate finance. The purpose of the Cap & Floor scheme is to reduce risk and encourage increased investment (from non TSOs) in electricity interconnectors in Great Britain. This Consultation is a recognition that the default Cap & Floor scheme does not provide appropriate certainty or risk allocation for private developers to obtain project finance, which is an important key to unlocking the additional investment which is the purpose of the Cap & Floor scheme.

The Consultation and the assessment of the requested variations therefore must focus on how variations (if allowed) enable project finance in a manner which remains ultimately in the interest of UK consumers, based on an impact assessment using realistic scenarios and associated assumptions. Our view is that Ofgem's approach to assessing the costs, risks and benefits of the proposed variations is suitable but we note that the results of this assessment rely heavily on assumptions which are subjective and difficult to assess. As we set out below, we have identified some assumptions which we consider to be particularly mis-judged and which would have a material impact on the assessment made and the ultimate minded-to position of Ofgem in this Consultation.

For example, we consider Outcome B to be unrealistic for most non-TSO developers and therefore the probability associated to this outcome should be low, and much lower than the probability ascribed to it by Ofgem. In our view, there is not an outcome for a developer seeking project finance in which such a financing process is unsuccessful with the consequence that the project is delayed but ultimately funded on balance sheet. Instead, the outcome is either that, project finance is obtained on terms acceptable to equity investors and compatible with the regime (as revised) – in which case a project proceeds - or not, in which case the project cannot proceed with its initial developer. Such a developer could in theory try and sell the project to another investor (who we assume is equally unable to secure project financing) who is capable of financing the project on balance sheet or with some other corporate financing; however, (i) we don't consider this to be the result Ofgem envisaged for Outcome B, and in any event (ii) we do not consider this outcome to be credible in practice. In such a case, the project would have already been delayed by the unsuccessful project financing and would be further delayed by a sale process and the consequent implementation of balance-sheet financing. In the absence of Variation 5 being accepted, the remaining regime length would be significantly reduced, reducing the profitability and attractiveness of the project to the point of abandonment. Outcome B thus seems improbable and certainly not consistent with the premise of addressing variations designed to facilitate project financing solutions.

As we set out further below, the probabilities attached to the various Outcomes and Options (as set out in the Impact Assessment) have a material bearing on Ofgem's assessment and ultimate minded-to decision to approve Option 3. Reconsidering these probabilities and uncertainties (and some of the costs of the proposed variations) would in our view result in strongly increased benefits associated with Option 4 (as compared to Option 2 or Option 3).

Finally, as mentioned above, we would highlight that due to the nature of development projects it is not possible to identify all the issues that may arise before the financing process begins. Some issues may be unique to a project and only arise as a result of lender review of project documentation during the financing process. Accordingly, we believe that the FPA process should be reviewed in that context. A staged or iterative approach is recommended to deal with this issue as outlined above.

Question 5: Do you have any views on the specific qualitative or quantitative analysis published in our Impact Assessment?

Probabilities

We have explained above why, in our view, Outcome B is not considered a realistic outcome where developers are unable to progress a project through a project finance solution.

Consequently, this introduces a bias into the probabilities of the various scenarios modelled by Ofgem in its Impact Assessment.

Overall, we consider that Table 3 of the Impact Assessment (which sets out the various probability ranges for each Outcome under each Option) does not fairly or sensibly reflect a realistic set of assumptions. In particular:

- Variation 4 would strongly improve the ability to finance a project from both lenders' and equity points of view. The associated range of probability of Outcome D in Option 4 should therefore be narrower and higher;
- In addition, the range of probability for Outcome D in Option 4 should be materially higher than the same probabilities under Option 3;
- Consequently, the probability of Outcome A under Option 4 should be low (25% seems excessive); and
- As explained above, we would also see probabilities of Outcome B to be very low under all Options.

We set out below a revised set of probability assumptions reflecting our own views. We would invite Ofgem to update its Impact Assessment calculations based on these probabilities which, in our view, will reflect the additional benefits of Variation 4, and thus the merit of Option 4 compared to Option 3.

Table 1: Suggested probability estimates range attached to Outcomes A, B, C and D

Outcomes (probability, %)	Option 1 (Counterfactual)		Option 2 (V1)		Option 3 (V1,2,3)		Option 4 (V1,2,3,4)	
	Scenario 1	Scenario 2	Scenario 1	Scenario 2	Scenario 1	Scenario 2	Scenario 1	Scenario 2
Outcome A	100	85	80	65	20	30	10	0
Outcome B	0	10	10	10	0	5	0	0
Outcome C	0	5	10	15	55	30	20	10
Outcome D	0	0	0	10	25	45	70	90

Calculation of costs

Appropriately, Ofgem seeks to quantify the cost associated with each proposed variation in its Impact Assessment. We have identified two areas of challenge with Ofgem's approach to calculating these costs. They relate to the costs associated with Variation 2 and Variation 4.

Costs of Variation 2

To calculate the costs of Variation 2, Ofgem seeks to calculate the cost of making top-up payments in the event availability falls below 80%.

The Impact Assessment does not explicitly identify the unplanned availability (forced outage rate) assumed in order for projects to fall below the threshold but this can be inferred on the basis of the cost assumptions used to determine the cost of the variation. Ofgem's approach has been to assume the amount of the floor which would be required to be borne by consumers for a given period of time in each scenario – 50% of the floor for 1 year in the low case, 50% of the floor for 3 years in the high case. This infers an additional forced outage rate of 2% in the low case, 4% in the central case and 6% in the high case over and above any outage which has brought an interconnector to the 80% availability threshold.

On the basis of the report referenced by Ofgem in footnote 22 ("Calculating Target Availability Figures for HVDC Interconnectors – Update August 2016" by GHD consultants), GHD estimate unplanned (forced) outage rates for HVDC converters to be 0.63%. While we support Ofgem's minded-to position on Variation 2, we believe the outage rates assumed to calculate the costs of Variation 2 (given we are already assume a level of availability underperformance in this scenario) to be aggressive and therefore results in an overstatement of the costs of Variation 2. The impact of this is to understate the benefits of both Options 3 and 4. In our view, a central cost case assuming an additional 0.5%-1.0% forced outage rate would be more appropriate in respect of Variation 2 (compared to Ofgem's 4%).

Costs of Variation 4

Regarding the cost of Variation 4, we have noticed one assumption made by Ofgem which tends to overestimate these costs in the high cost scenario.

We acknowledge this has a limited effect on Ofgem's decision making, since the final analysis is based only on the central cost scenario. However, we make this observation in order to ensure consistency of the full impact assessment.

We understand the assumptions made by Ofgem in terms of gearing to be the assumed gearing output, once the "actual cost of debt approach" is applied, i.e. applying debt cost parameters in order to reach the targeted debt service cover ratio and gearing levels. Thus, the outcome gearing should be the targeted gearing level, which Ofgem assumes to be 80% in the central case, which we consider a reasonable assumption at this stage. In the low-cost scenario, one might imagine the lending market is depressed, and available conditions are more restrictive, thus a lower gearing around 70% is also a reasonable assumption in this scenario.

However, in the high cost scenario, the 90% assumed gearing level is not realistic, as this would be far in excess of what lenders would be willing to consider for this class of asset and specific risk. Furthermore, we understand the "actual cost of debt variation" to be limited to the debt parameters enabling the project company to reach the targeted gearing level – here 80% and not above – while keeping the floor amount to the minimum value enabling this gearing value to be reached; consequently, in this case, the cost of debt would not result in the assumed 225 bps level above iBoxx, but instead limited to such minimum level enabling to reach the target 80% gearing.

III. Ofgem's proposals and next steps

Question 6: Do you agree with our proposed approval of the requests to reduce the default revenue assessment period, to make changes to the minimum availability threshold at the floor, and to broaden our definition of force majeure?

1. Reduce the default five-year revenue assessment period to one year

We welcome Ofgem's minded-to position to change the interval between assessments from five years to one year.

Project financing is primarily structured on a cash-driven basis, relating to a ringfenced, special purpose vehicle acting as the borrower. This borrower will conduct one single business which will be its unique source of revenues. Lenders will rely solely on the borrower (and have no recourse at all against its shareholders) to service its debt interests and reimbursement payments. The basic principle of project finance is thus to ensure the project company's available cashflows match (as far as possible) the debt service requirements.

Debt service for project financing is usually paid quarterly or half-yearly. Lenders will thus assess the project company's capacity to make debt service payments on a half-yearly basis based only on the revenue generated by the project company

However, the default regime's 5-year assessment and payment schedule lead to the floor being ensured, ex post, only every 5 years on an aggregate basis. To the extent the floor top-up payment is triggered, this creates a very significant time gap between the dates on which debt service is due and the dates on which the project company actually receives the floor top-up payments, and thus creates significant volatility in project company's cashflows. This would be unacceptable from a lenders' point of view unless significant liquidity reserves are being built into the structure, which would result in significant inefficiency and cost. In our view, this alone would either totally jeopardize the availability of project financing to interconnector projects or otherwise increase the cost of debt to levels which are unbearable to developers and equity holders (and ultimately to UK consumers if floor levels were appropriately adjusted).

Switching to a half-yearly or yearly assessment period significantly reduces this time gap and is thus critical to ensure both (i) feasibility of a project financing, and (ii) efficiency of costs ultimately underwritten by UK consumers.

We note that whilst Ofgem's minded-to position should be welcomed by consumers and developers, the benefits of utilizing a half-yearly or yearly review period will be significantly negated if the mechanism

by which payments (especially floor top-up payments) are made is not adjusted to ensure payments are made promptly after the end of the half-year / one-year assessment period. We have commented above on this issue and note NeuConnect's additional variation request relating to NETSO payments. We would urge Ofgem to look closely at this issue in order that lenders do in fact treat the variation in the manner intended by Ofgem and so that developers do not face the prospect of punitive liquidity reserves being imposed on them.

2. Consider changes to the principle underpinning the minimum availability threshold of 80%

We welcome Ofgem's minded-to position in this regard and note that Ofgem are seeking further feedback on how the variation might be implemented. We comment above in response to question 5 specifically on the calculation of the costs of this variation, which goes to the overall decision by Ofgem to select Option 3 over Option 4.

As explained above in relation to Variation 1, the floor amounts will be the basis on which lenders will establish the level of project leverage. When performing this assessment, lenders will focus on the "quality" of the generated cashflows, including in particular their degree of certainty. This is generally done by running downside stress cases, applying adverse or more conservative assumptions into the business case, and analysing the impact it has on the project company's capacity to service its debt payments.

The current default regime introduces a high degree of cashflow uncertainty by virtue of the 'cliff-edge' nature of the minimum availability threshold (because a project company would lose its right to receive floor top-up payments in the event that the project's actual availability is below the minimum threshold). When running cases of severe availability downside cases, the project company is therefore incapable of servicing its debt.

From GridLink's initial discussions with lending institutions, this binary situation results in significant cashflow impacts which serve to limit the bankability of the regime. Accepting the variation is therefore an important move towards making the regime bankable for project finance.

We do, however, believe that the details of this proposed variation are critical. While we intend to thoroughly analyse and test alternative options with lenders in more detail as part of our own request for variations, we would welcome further discussion with Ofgem on this topic as part of this Consultation. If there are details in any final proposal relating to Variation 2 which nevertheless create a "cliff-edge" (not at 80% but at some other availability threshold) or which otherwise pose uncertainty to floor payments under the scheme, then developers will be forced to incur costs either in the cost of debt or elsewhere in project contracts (e.g. in enhanced O&M packages) in order to mitigate the risks which project finance lenders will factor into their evaluation - with such costs ultimately still being borne by consumers.

Of the structural options presented in the Consultation which are relevant to this issue, we would agree with a combination of the proposals made by GreenLink and NeuConnect – that is, (i) floor top-up payments should continue even when a project is below the 80% availability threshold, but such amounts should be paid back from revenues once above the floor on an NPV neutral basis, and (ii) the floor should never be automatically switched off but should be paid unless and until Ofgem issues a direction (whether for force majeure or otherwise). The combination of these two approaches will increase certainty for lenders, subject to appropriate payment mechanics being developed.

3. Broaden the definition of force majeure under the default regime to include additional events necessary for enabling project finance funding

We welcome Ofgem's minded-to position in this regard.

Our view, as corroborated by initial discussions with the lending community, is that the current force majeure definition of the default regime (based on license drafting for precedent Cap & Floor projects) is much narrower than what is usually seen on other infrastructure projects. This is of particular importance when considering events which are beyond the project company's control (or even caused by third parties) and which are not insurable.

We therefore suggest the following types of event are specifically included as examples of force majeure:

- I. Weather, ground conditions and marine conditions, including storms, lightning strikes, tidal activity, earthquakes, subsidence, fire, flood, drought and accumulation of snow or ice.

These events are typical "Acts of God" that are outside a developer's control. The developer can bear the risk of, and adequately plan for, normal conditions which it is aware of and can reasonably prepare for. However the effects of extreme cases cannot be reasonably managed by the developer (e.g. extreme weather conditions, natural disasters, tidal surges etc., or unusually prolonged or unseasonal adverse weather conditions).

- II. Actions caused by shipping, fishing and other marine activities of third parties (including anchor drag, spills, collisions and maritime disasters).

These acts by third parties on busy shipping lanes and fishing routes are beyond the developers control and (whilst not excluded by the default definition) should be specifically included.

- III. Anticipated and actual change in taxation, tariffs, law or regulation (including a change in the interpretation of the same) or a governmental intervention.

Whilst "governmental restraint" is included in the default definition this phrase is unclear and arguably does not provide protection for changes in law or other types of government intervention that may hinder or prevent (or increase the costs) of developer performance. This should also include anticipated changes in law as a developer will need to take action to prepare for new legislation or legislative changes (which, in itself, can lead to delays and cost increases).

- IV. Damage and delay caused by the TSO on either side of the interconnector

The grid works required to connect the project are essential to the ability of the developer to meet project milestones and the TSOs may not be sufficiently incentivised to meet target dates for work commencement and completion; overrun on these works has the potential to create knock-on delay and increased costs to the developer's own works - this is beyond its control.

Question 7: Do you agree with our proposal to reject the requests to use a project-specific actual cost of debt and gearing, and to maintain a 25-year regime duration?

4. Use project-specific actual cost of debt and gearing to set the Cap & Floor levels, rather than the default notional cost of debt and gearing

Our fundamental position is that a project specific approach to gearing and cost of debt results in the optimal outcome for all stakeholders. As such, we disagree with Ofgem's minded-to-position in this regard with reference to the reasons below.

The current default regime relies on a building block methodology which foresees the use of a notional approach for the computation of the "cost of debt" block, rather than the use of the actual cost of the debt being raised by the project company. This notional approach is based on an iBoxx benchmark as proxy for the cost of the project's debt.

iBoxx not suitable as cost of debt proxy for non-recourse project finance

The table below provides a list of European interconnector projects which have been financed to date, together with the sources of capital used to fund their construction. As can be seen, all but one of the interconnectors (Moyle) which have been financed to date have been financed at the corporate level rather than at the project level and all but one (Eleclink, not Cap & Floor) are owned by TSOs.

Interconnector Project Financing - Sources of capital

Project	MW	Source of Capital
IFA II	1,000	TSO – corporate level
IFA	2,000	TSO – corporate level
NSL	1,400	TSO – corporate level
Nemo	1,000	TSO – corporate level
Celtic	700	TSO – corporate level
Viking	1,400	TSO – corporate level
NorthConnect	1,400	TSO – corporate level
BritNed	1,000	TSO – corporate level
NorNed	700	TSO – corporate level
Monita	1,000	TSO – corporate level
Cobra	700	TSO – corporate level
Nordbalt	700	TSO – corporate level
Inelfe	2,000	TSO – corporate level
Biscay	2,000	TSO – corporate level
Western Link	2,200	TSO – corporate level
ElecLink	1,000	GetLink - corporate level
Moyle	500	Infrastructure Bond

It is notable that none of the interconnectors has obtained project level project financing. TSO's and large corporates have multiple sources of revenue and their revenue streams are not dependent on a single asset. Consequently, they can secure different types of financing at competitive interest rates. We consider that iBoxx is a suitable benchmark to be applied to calculate a cost of debt for a TSO, or TSO-like entity which has multiple revenue streams to support balance sheet financings (i.e. where project level financing is not being pursued) and we expect this is why the iBoxx benchmark was included in the default regime.

However, project finance is very different in nature. The availability and cost of project finance, of the type being sought by interconnector projects currently being developed (and of the type which Ofgem is seeking to enable through variations to the default regime), is determined solely on revenues generated by the relevant project (in this case underpinned by the floor payments of the Cap & Floor regime). The risk profile for lenders is thus justifiably very different compared to corporate level balance sheet financings. The cost of debt reflects this risk and is focused on the certainty of the underlying revenues. There is no available benchmark index which captures the very specific nature of interconnector revenues as regulated by Ofgem's Cap & Floor scheme. So whilst iBoxx is a suitable index for a wider range of corporate financing solutions (which might be available to TSOs and corporates), it is not a suitable index as a proxy for the cost of debt for a project financing solution. The only fair measure of the cost of debt for any project pursuing project financing in these circumstances is the actual cost of debt.

While the Moyle interconnector may be an exception to the rule regarding corporate level financing of interconnectors, it in fact neatly demonstrates the all-important nature of the underlying revenue generation of a project when considering project level financing (which in this case was a bond issuance) Moyle was able to finance in this way at the project level because the Moyle project benefited from the following key provisions in its applicable regulated regime, which in turn allowed it to issue A3 rated (low coupon) bonds (issued 2003):

- 100% of revenues are guaranteed;
- Operating costs/debt service is still recoverable even if the cable is unavailable;
- Unexpected costs (e.g. repairs) can be recovered the following year by an increase in tariffs;
- Any shortfall in revenues can be recovered (via tariff increases) from consumers within 14 months; and

- It has an allowed debt service reserve of 14 months, allowed debt coverage ratio of 1.3x, plus an insurance policy unconditionally guaranteeing bond payments during the 14 months period priced at 0.250%/year on the outstanding balance of the bond.

Were the Cap & Floor scheme similarly structured, project finance would almost certainly be available, and probably at a cost of debt similar to, or even slightly below, the iBoxx benchmark. The key point here is that it is the terms of the scheme which will determine lenders' assessment of the cost of debt and so the variations being proposed and considered by Ofgem are each critical and should be paired with a floor calculation based on the actual cost of debt. We consider that using a notional benchmark index as a proxy for cost of debt is inappropriate and will also result in the issues we set out below.

Misalignment with revenue floor

A notional approach to the cost of debt, by construction, creates a misalignment, and thus uncertainty for lenders between the project's regulated floor revenues and the project costs, as actual finance costs will materially deviate from the floor-allowance for financing costs. From our conversations with lenders we understand that in order to compensate for the uncertainty brought about by the misalignment, lenders will likely factor some headroom into the financing structure be it higher financing fees or reduced leverage, both of which are likely to result in sub-optimal outcomes for consumers in comparison to a situation where Ofgem's building block methodology would be based on the project's actual debt terms and conditions.

Misalignment with realized market costs

The iBoxx benchmark reflects a wide range non-financial companies with a credit rating of A/BBB. According to Moody's rating methodology, Baa utilities should exhibit gearing ratios of between 60-75% and 45-60% for A rated utilities respectively. On the assumption that project companies are free to adopt the most efficient capital structure, for the benefit of all stakeholders, it can be envisaged that gearing ratios of between 60-80% will be adopted across projects. Under these circumstances however projects will continue to be benchmarked against an index which includes A rated companies with significantly lower costs of debt and gearing between 45-60%, and as a result fail to compensate projects in-line with realized costs. It is our view that this example is in fact a very likely one and demonstrates the undesired impact that utilization of the iBoxx index as a benchmark may result in.

It is also of note that the 25-year term of the Cap & Floor scheme (including lending tails on financing arrangements) far exceeds the minimum 10-year requirement for liquid A/BBB credit instruments to be included in the iBoxx index. By construction therefore, the index will have a degree of weighting to 'shorter term' financing rates in comparison to the term premium that Cap & Floor projects will likely experience

We also note that the proposed iBoxx benchmark assumes that the project company is able to access credit markets on comparable terms with liquid investment grade bond issues whilst in reality project companies will unlikely be able to benefit from the 'liquidity discount' that such bond issuers are able to benefit from.

Other unintended consequences

Our conversations with lenders have highlighted that even under a non-recourse financing structure banks are focused on shareholder incentivization to ensure that project owners are adequately incentivized to operate assets in the long term rather than focusing on short term optimization. In the case of Cap & Floor projects this implicitly assumes that equity investors should be sufficiently compensated in the event that the project yields floor revenues.

Feedback and experience from lenders highlights that when equity investors, under similar regulatory frameworks, are not sufficiently compensated in 'downside scenarios' akin to receiving floor revenues, there is an increased tendency to adopt short-term oriented solutions (i.e. maintenance costs being deferred, opex reduced to a minimum) to ensure debt service obligations are met, though at the expense of the long term condition of the asset and the indirect impact on consumers.

Finally, we note that from the perspective of an equity investor utilizing the iBoxx benchmark could sufficiently alter the economics of the project to cause delays to development and construction and/or project abandonment which in turn could result in a suboptimal outcome for consumers.

Way forward

Based on the submissions above and on feedback received from lenders, we are convinced that a floor based on the actual cost of debt would: (i) genuinely enable project financing solutions (in a way which Option 3 does not) and in manner not reflected in the probabilities assumed by Ofgem in Table 3, (ii) maintain a fair allocation of risk between developers and consumers. Variation 4 is as critical to enabling project finance as Variation 2 and will this enable projects to proceed and realise the significant consumer benefits of further interconnection.

A critical feature of approving Variation 4 is to properly ensure that developers do undertake a competitive financing process. Such processes are commonly undertaken by the market and will be familiar to lenders and developers alike. Implementing a process which demonstrates this to Ofgem is readily achievable. We would urge Ofgem to reconsider its position on Variation 4 in this light.

5. Maintain 25-year regime length

The 25 year duration of the Cap & Floor regime enables access to the longest financing tenors which in turn reduce annual payments. A shorter regime would shorten the tenor and would result in higher annual payments and result in higher tariffs to consumers.

We sympathise and agree with Ofgem that poor performance should not be rewarded, and if a project is unable to achieve its agreed commissioning date due to its own action or inaction, then it should be penalized and the length of the regime be shortened accordingly. That will undoubtedly cause problems for both debt and equity and therein lays the incentive for both debt and equity to ensure the project is progressed in a professional and efficient manner.

However we do not believe the length of the regime should be shortened where a project promoter can demonstrate that a delay was caused by events beyond its reasonable control and the promoter is using all reasonable endeavours to mitigate the delay. This principle is in fact already accepted under the definition of force majeure which is applicable when the project is in operation. We do not see why therefore the same principle should also not be adopted during the development and construction stage of the project. Indeed this is precisely where the most significant delays can occur. We accept that certain issues may arise which result in a delay should not be considered as an acceptable reason for not meeting the commissioning date. Planning permission is a good example. A delay in obtaining planning permission due to objections or a public inquiry can easily add 1-2 years to a development schedule. However we are of the view that project promoters are free to choose where to locate their developments and conduct public consultations and are free to choose how they respond to any concerns that are raised. So we would accept that a delay in obtaining planning consent should not be deemed an acceptable reason for not meeting the agreed commissioning date.

However where a project promoter relies on the application of law, and that law has not been applied by competent authorities (or where there has been a change in law), we feel that is an acceptable reason for not meeting the agreed commissioning date. A good example of this is where a national regulatory authority has maintained that only the incumbent TSO may own and operate regulated interconnectors despite European legislation specifically providing for the contrary. Indeed ACER has itself noted that project promoters are entitled to rely on the application of European legislation.

Therefore we feel it appropriate where competent authorities have not implemented or followed applicable law, or where there has been a change in law which results in delay, it would be reasonable to seek an extension to the commissioning date without suffering a penalty. We would urge Ofgem to reconsider its position on Variation 5 in this light.

Question 8: Do you have any views on the conclusions from our draft IA, or our early thinking on risk mitigation?

As described in detail in our responses above, we are of the opinion that:

- The methodology used by Ofgem in its Impact Assessment to assess the variations proposed is sound.
- However, we have identified certain assumptions which have a material impact on the net impact to consumers of the proposed variations. In particular, we have identified:

- cost assumptions which in our view overestimate the costs of Variations 2 and 4 (ultimately to the detriment of Option 4); and
- flawed probability assumptions which (i) allocates probability to Outcome B (in our view, in error), (ii) overstate the impact of Option 3 to enable projects to proceed with project financing, and (iii) understate the impact of Option 4 to enable projects to proceed with project financing.
- As a result, we consider that Ofgem's assessment to prefer Option 3 to Option 4 is based on flawed cost calculations and probability assumptions.
- Were Ofgem to re-perform its impact assessment using the revised cost and probability assumptions set out in our response above, we believe the benefit of Variation 4 would be properly reflected in the results.
- Consequently, we are of the view that Option 4 (with appropriate safeguards in respect of Variation 4) should be preferred to Option 3 as it would most likely lead to the realization of project financed interconnector projects and thus the realization of significant consumer benefits.
- Finally, we would urge Ofgem to reconsider its position in respect of Variation 5.

We are very aware of the importance of the Consultation, particularly its outcome, to the prospects of realizing the GreenLink and NeuConnect projects as well as future interconnector projects (including our own). While this Consultation deals with the key issues with the default regime, it does not deal with all relevant issues to enabling the efficient use of project finance (such as the FPA process itself) and nor does it deal with the finer detail of the proposed variations which will be critical if the approved variations are to have the positive impact assumed by Ofgem. It is unclear to us whether decisions made by Ofgem regarding the proposed variations will include the level of detail (absent from the Consultation) that will be important for developers and lenders alike to assess the impact of the variations.

Finally, we would like to thank Ofgem for giving us the opportunity to respond to the Consultation and we would be very happy to engage further with Ofgem on all or any part of these submissions to assist in creating a fair and balanced Cap & Floor scheme which genuinely delivers on the policy intention to ensure the regime is suitable for project financing solutions.

Yours sincerely

The GridLink Interconnector team

