

Office of Gas and Electricity Markets (Ofgem)
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United Kingdom

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RESPONSE TO OFGEM'S CONSULTATION ON THE INTERCONNECTOR POLICY REVIEW: WORKING PAPER 1 – REVIEW OF THE CAP AND FLOOR REGIME

Introduction

AQUIND Interconnector welcomes the opportunity to respond to initial proposals for the future of the Cap & Floor (“C&F”) regime for interconnectors in Great Britain (“GB”) that have been developed as part of Workstream 1 of Ofgem’s Interconnector Policy Review (“IPR”).¹

AQUIND Interconnector is a proposed high voltage direct current (“HVDC”) interconnector between GB and France that will facilitate improved electricity transmission connection between the two markets. The subsea cable will connect the South Coast of England with Normandy and provide 2,000 megawatts (“MW”) of additional cross-border capacity.² The project is expected to make energy markets more efficient, improve security of supply, help meet decarbonisation targets and, ultimately, ensure greater reliability and affordability for consumers.

The project has been under development since 2014 and has met a number of key milestones (including obtaining connection agreements in both countries and an operational license in GB), completed detailed environmental surveys, and initiated the relevant permitting processes in the UK and France. The project has also completed the first stage of a public tender for EPCI contracts to build the components of the interconnector. Together with our advisors, we have been actively involved in interconnector policy development in GB and France in recent years.

Summary

We welcome the opportunity that the IPR presents to consider the performance of the C&F regime to date and the changes that may be appropriate to make going forward. We are broadly supportive of the approach that Ofgem has taken to this workstream.

We agree that the C&F regime has been an important mechanism for incentivising the development of further GB interconnection capacity. We consider that a key strength of the regime has been the

¹ <https://www.ofgem.gov.uk/publications/interconnector-policy-review-working-paper-workstream-1-review-cap-and-floor-regime>

² <http://aquind.co.uk/>

developer-led approach, which has ensured access to a wide pool of resource and capability, encouraged the design of alternative financing structures, and promoted innovation.

However, we consider that the regime has been only partially successful in enabling investment from a wide range of market participants, including third-party developers.³ While some progress has been made to enable independent entrants to participate in the market in recent regulatory decisions,⁴ more can be done to ensure a level playing field between different types of promoters, and especially between balance sheet investors and project finance developers.

We agree with Ofgem's intention to review the C&F regime and identify improvements. We consider that any proposed improvements should be targeted to address specific areas of weakness in the C&F regime, to ensure that the key principles and original objectives of the C&F regime are retained.

However, we have concerns that Ofgem's initial proposals for Workstream 1 and the general direction of travel for the IPR may undermine the continued success of the C&F regime. While we do not believe this is Ofgem's intention, we are concerned that the proposed changes to the C&F regime will reduce investor confidence, narrow down the potential pool of third-party investors, and lead to a 're-centralisation'⁵ of interconnector development.

As an independent, third-party interconnector promoter, we have considered the initial proposals put forward by Ofgem for how the C&F regime might be improved going forward. We set out our full response to Ofgem's proposals in our responses to Questions 1-11 below. Our main points are that:

- ▶ **A key strength of the C&F regime is the developer-led approach.** This has been particularly attractive for investors and allowed promoters to develop projects in line with their individual investment and development objectives and drawing on their organisational expertise. This has led to significant benefits in terms of consumer and societal welfare, which have been made possible by developers being able to identify the most viable opportunities based on their own knowledge, expertise, and analysis. However, the possibility of a more "centralised" approach put forward by Ofgem, which envisages an "enhanced" role for National Grid Electricity System Operator ("**NG ESO**"), represents a marked shift away from the developer-led principles of the C&F regime and undermines the purpose of the regime.
- ▶ **A more proactive role for NG ESO may lead to system operability being disproportionately prioritised in future assessments relative to the wider socio-economic impacts of additional interconnection.** Over-weighting of system operability impacts will lead to sub-optimal outcomes for consumers, as socio-economic welfare gains might be sacrificed to achieve more marginal improvements in operability and/or network cost reductions.
- ▶ **The limited number of application windows has restricted promoters' ability to access the regime and must be resolved promptly.** We consider that ongoing case-by-case applications by mature projects (Option 1) would address this issue. We are also broadly

³ Specifically, there have been relatively few successful projects brought forward by third-party developers relative to the number of projects put forward by National Grid Ventures, and significant challenges remain for project finance developers.

⁴ Ofgem (2021), Decision on proposed changes to the electricity interconnector licences held by Greenlink Interconnector Limited and NeuConnect Britain Limited.

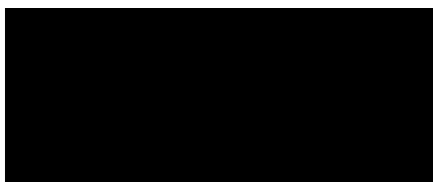
⁵ I.e. a situation where decisions regarding the location and nature of future interconnectors are effectively determined by a central planner with limited competition for the necessary investment.

supportive of cyclical investment rounds with guaranteed regular application windows that take place at least every two years, if not more frequently (Option 4). We do not support Option 2 and Option 3 as set out in Working Paper 1.

- ▶ **There are material risks associated with setting stricter eligibility criteria for developers applying for the C&F regime.** Specifically, it is unclear to us how a suitable criterion would be defined *a priori* in a way that does not disadvantage projects that may appear less advanced or favour projects that have strong links to national transmission system operators (“TSOs”). An ill-defined criterion could be used to pre-determine winners and hinder participation from a wide range of market participants. We therefore welcome the fact that Ofgem recognises that caution must be applied when developing any such maturity criteria, and recommend that Ofgem also considers a range of alternative approaches.
- ▶ **Assuming that all projects that have been awarded the C&F regime in the past will become operational risks undervaluing the benefits of future interconnection.** This review is an opportunity for Ofgem to develop an up-to-date view on the level of capacity that is likely to materialise going forward and use this view as a new baseline against which to assess the benefits of future interconnection. Doing otherwise would risk understating the benefits of future interconnection.
- ▶ **Further action is needed to ensure a level playing field and enable non-TSO entrants to participate in the market.** The current review presents an opportunity to incorporate the regime amendments that were awarded to Greenlink and NeuConnect as permanent features of the C&F regime and develop more tailored routes for balance sheet investors and project finance developers.
- ▶ **Further GB interconnection will enable significant socio-economic and wider benefits to GB consumers.** Our own analysis suggests that further GB interconnection will offer significant socio-economic welfare benefits to GB consumers and GB society more broadly.

For any questions regarding our response please do not hesitate to contact me at kirill.glukhovskoy@aquind.co.uk.

Yours faithfully,



Kirill Glukhovskoy

Managing Director

Response to individual consultation questions

Section 2

Question 1: Do you agree with the approach we have taken to workstream 1?

We are broadly supportive of the approach that Ofgem has taken to Workstream 1, and welcome the opportunity that the IPR presents to consider whether the design and the application of the C&F regime continues to support Ofgem in delivering its regulatory objectives and encouraging further interconnection in GB.

An important achievement of the regime has been its ability to bring forward investment from different types of investors. However, we are concerned that some of Ofgem's initial proposals may risk undermining investor confidence and therefore narrowing the extent of investor participation. We are also mindful that any delays to existing interconnector projects associated with the IPR are likely to have an adverse impact on GB consumers, and would therefore encourage Ofgem to resolve any issues arising out of the review promptly.

Question 2: Do you think we have missed any important strengths, weaknesses, opportunities or threats when critically assessing the cap and floor regime?

We consider that a key strength of the C&F regime that has not been considered fully in Ofgem's analysis is the developer-led approach. This has ensured the availability of a wider pool of resources and expertise for interconnector development, encouraged the design of alternative financing structures, and promoted innovation. The regime has been particularly attractive for investors (who are often prepared to take on more risk than TSO developers) and allowed promoters to develop projects in line with their individual investment and development objectives, which may deviate from centrally-held notions regarding the attractiveness or bankability of projects. To date, this has led to significant benefits in terms of consumer welfare, which have been made possible by developers being able to identify the most viable opportunities based on their own knowledge and expertise, and independent developers in particular being willing to take on greater levels of risk than their TSO counterparts. Similarly, ensuring consistency of approach for offshore wind has made the UK a global leader in offshore wind power generation capacity.

We agree that the flexibility to request regime variations is a positive intervention that has improved the ability of independent and project finance developers to participate in the market. Indeed, the IPR presents an opportunity to incorporate the regime amendments that were awarded to Greenlink and NeuConnect⁶ as permanent features of the C&F regime and develop other possible adaptations of the regime and more tailored routes for balance sheet investors and project finance developers, as proposed by market participants. This would address the weakness identified by Ofgem in relation

⁶ Ofgem (2021), Decision on proposed changes to the electricity interconnector licences held by Greenlink Interconnector Limited and NeuConnect Britain Limited.

to the challenges faced by project finance developers when applying for, and progressing through, the C&F regime.

In our view, the existing eligibility criteria and CBA methodology are not necessarily weaknesses of the current regime. Indeed, the existing eligibility criteria⁷ strike a balance between providing a wide range of market participants access to the C&F regime and screening out projects that are yet to achieve a sufficient level of maturity. We recognise that it may be appropriate to review the eligibility criteria to consider whether they are indeed effective in screening out less-developed projects. However, we would encourage Ofgem to exercise caution in setting stricter criteria, which could easily disadvantage independent projects or favour projects that have strong links to national TSOs. Ultimately, such criteria could be used to pre-determine winners rather than encourage participation from a wide range of market participants. We set out more detailed feedback on Ofgem’s proposed “maturity criterion” in our response to Question 5 below.

As regards the CBA methodology, we consider that the current methodology represents a well-established approach for measuring the socio-economic benefits of interconnection that accrue to consumers, producers, developers, and wider society. However, it is critically important that the merits of new interconnection are considered against an appropriate baseline of existing projects.

We agree with Ofgem that a window-based approach is a weakness of the current regime that must be resolved promptly. The limited number of windows that have been open in recent years has had two consequences. Firstly, it has created a seemingly large number of projects coming to the market at the same time, which has raised concerns about supply chain capacity. Second, it has restricted other promoters’ ability to access the regime and led to significant delays in project development and, ultimately, lost benefits to consumers. We are supportive of changes to the C&F regime that allow better access for developers, including ongoing case-by-case applications by mature projects (Option 1) or, alternatively, cyclical investment rounds with regular application windows that take place at least every two years (Option 4). We do not support Option 2 and Option 3 as set out in Working Paper 1. We set out more detailed feedback on Ofgem’s proposed options for application windows in our response to Question 5 below.

Finally, we consider that the IPR is also an opportunity to review the approach for considering projects that were previously awarded the C&F in Window 1 and Window 2 but have not been able to make substantial progress in recent years. There are several projects that have been awarded the C&F regime in previous windows that have not progressed towards commercial operation. Assessing the need for further interconnection relative to this baseline risks undervaluing the likely benefits of future interconnection.

Section 3

Question 3: Do you agree with our conclusion that the cap and floor regime has met its objectives to date? Is there any other information you think we should take into consideration in our analysis?

⁷ Eligibility criteria for Window 2 is provided [here](#).

We agree that the C&F regime has been an important mechanism for incentivising the development of further GB interconnection capacity since its introduction in 2013/2014. This has manifested itself in the range of projects that applied for the regulated route during the first two C&F application windows in 2014 and 2016. The developer-led approach has been particularly helpful in attracting investment, and enabled promoters to develop projects in line with their investment and development objectives and drawing on their local expertise and experience.

However, the C&F regime has been only partially successful in enabling investment from a wide range of market participants, including third-party developers. Although the first two C&F windows drew applications from a wide range of project developers, the only projects that have been completed successfully under the C&F regime (i.e. Nemo Link, IFA2 and NSL) have been promoted by TSO developers. At the same time, links promoted by third-party developers are not expected to become operational before 2024/2025. We hope that greater encouragement for third-party developers will be forthcoming in future C&F processes.

Further, there are several projects that have been awarded the C&F regime in previous windows that have not progressed as expected. The likelihood of such projects proceeding needs to be reviewed along with newly applying projects.

Question 4: Do you agree that the principles of the cap and floor regime remain fit for purpose and suitable to potentially incentivise further GB interconnection?

We are broadly supportive of the objectives and principles of Ofgem’s C&F regime. We consider that the C&F regime is based on sound economic principles and offers a good framework for attracting new interconnector investment from a wide range of developers.

However, while some aspects of the C&F regime remain fit for purpose, we believe that others ought to be reconsidered and revised to ensure that further GB interconnection capacity is actually delivered in the most effective way possible. Specifically:

- ▶ **We consider that a developer-led approach to the C&F regime is beneficial and preferable to a more centralised approach.** It draws on a wider pool of resources and expertise for interconnector development and has encouraged the design of alternative financing structures and promoted innovation. The regime has been particularly attractive for investors and allowed promoters to develop projects in line with their individual investment and development objectives. We firmly believe that this has led to significant benefits in terms of consumer welfare.
- ▶ **While we recognise that some progress has been made to enable independent and non-TSO entrants to participate in the market, more can be done to ensure a level playing field for different types of market participants, and especially project finance developers.** For example, the regime amendments that were made for Greenlink and

NeuConnect⁸ should become permanent features of the C&F regime. Indeed, it would be helpful for Ofgem to develop clear, alternative routes for balance sheet providers and project finance developers to improve the overall fairness of the C&F regime.

- ▶ **The limited number of ‘windows’ that allow promoters access to the C&F regime has been an unhelpful feature of the current regime that requires prompt resolution.** As we explain in our response to Question 5 below, we are most supportive of ongoing case-by-case applications by mature projects (Option 1) and broadly supportive of cyclical investment rounds with regular application windows that take place at least every two years if not more frequently (Option 4). Indeed, we believe that the Interconnector team within Ofgem has gained a great deal of expertise and experience in evaluating interconnector projects since the C&F regime was first implemented in 2013/2014, and are confident in the team’s ability and capacity to assess new projects on an ongoing basis rather than periodically.

Section 4

Question 5: Do you agree with our initial proposals with respect to potential changes to the assessment framework of the cap and floor regime? Specifically:

- (a) To consider a more coordinated and system-wide approach to application windows, potentially informed by a more proactive role for NGENSO. Do you have any views on the options presented for our approach to potential future application windows?**
- (b) To review our eligibility criteria for any potential future regime, and to explore the potential to raise the maturity threshold for applicants.**
- (c) To consider changes to the current incentives mechanisms to help ensure timely delivery of projects. Do you have any suggestions for modifications or alternatives?**

As an independent, third-party interconnector promoter, we have considered Ofgem’s initial proposals in relation to the C&F regime in detail. We set out our comments on the proposed changes to different aspects of the assessment framework in turn below.

Application windows and the role of the ESO

Ofgem considers that, on balance, there is still merit in an application process based on windows but that a *“more coordinated and system-wide approach”* may be preferable going forward. We understand that this initial conclusion is based on concerns that relying exclusively on market price signals to identify future interconnector projects would lead to suboptimal outcomes from a system perspective, given the new decarbonisation agenda set out by UK Government and the energy system transformation that is needed to support it.⁹

Although always an important factor, the needs case for further interconnection is now more closely linked to the UK’s decarbonisation agenda than previously. Project promoters are well aware of the

⁸ Ofgem (2021), Decision on proposed changes to the electricity interconnector licences held by Greenlink Interconnector Limited and NeuConnect Britain Limited.

⁹ See BEIS (2020), Energy White Paper: Powering our Net Zero Future; HM Government (2020), The Ten Point Plan for a Green Industrial Revolution.

challenges posed by the need to transition energy systems away from traditional thermal generation and towards more intermittent renewables, and the role that sources of flexibility – including interconnectors – may play in this transition.¹⁰

However, we do not agree that this necessitates a more centralised approach to application windows informed by a more enhanced role for the electricity system operator (“ESO”) in GB, namely National Grid ESO (“NG ESO”). Indeed, these proposals represent a marked shift away from the ‘developer led’ principle of the C&F regime, which has been fundamental to the success of the C&F to date, and towards an effective ‘re-centralisation’ of interconnector development.¹¹

We firmly believe that Ofgem’s proposed changes will lead to a reduction in the transparency and legitimacy of the C&F regime. Specifically, the ongoing review of NG ESO¹² will take some time to complete and the model under which a future ESO will operate is still unknown. In the meantime, NG ESO has a particular interest in minimising the costs of operating the electricity system in GB, which may lead to system operability being disproportionately prioritised in future C&F assessments relative to, say, the socio-economic and wider benefits of additional interconnection. Indeed, it is unclear at this stage how the interconnectors’ contribution to system operability will be evaluated and how the evolution of the market design in GB will be taken into account. Further transparency is required to avoid a loss of investor confidence in the C&F regime.

Ultimately, a centralised approach will deter project finance developers from participating in the C&F regime and lead to a scenario in which the majority of interconnection in GB will be developed by the local TSO. This outcome would be in direct contrast to the intended purpose of the C&F regime.

As noted in our response to Question 4 above, we are most supportive of ongoing case-by-case applications by mature projects (Option 1). We believe that Ofgem has gained a great deal of expertise in evaluating interconnector projects since the C&F regime was first implemented and are confident in the team’s ability and capacity to assess new projects on an ongoing basis.

We are also broadly supportive of cyclical investment rounds with regular application windows (Option 4). However, we consider that application windows should take place at least every two years (if not more frequently) as longer intervals would hinder developers’ access to the C&F regime.

We note that Ofgem raises a specific concern in relation to Option 1 (which could also be seen to apply to a lesser extent to Option 4), which is the potential additional burden on Ofgem associated with an unpredictable stream of projects coming forward. We consider the potential for this to become a significant issue as unlikely. Based on National Grid’s recently updated interconnector register,¹³ we have identified a very limited number of projects that are at the ‘Awaiting Consents’ or ‘Consents Approved’ stage that do not have a C&F agreement in place already. Even under Option

¹⁰ See, for example, a recent report commissioned by Aquind on the role of cross-border transmission in the European transition to Net Zero (available [here](#)).

¹¹ I.e. potentially leading to a situation where decisions regarding the location and nature of interconnector requirements is effectively determined by a central planner and with limited competition for the necessary investment.

¹² Ofgem has recommended that the NG ESO becomes an independent system operator i.e. separate the ESO from National Grid Group completely putting it under different ownership (see [here](#)). Whether this transition actually happens and the timing on when it would occur remains unclear at this point in time.

¹³ See: <https://data.nationalgrideso.com/connection-registers/interconnector-register>

1 we would expect a relatively steady and predictable stream of projects. Alongside Option 1, Ofgem could introduce a system of ongoing engagement with the industry, which would signal some time in advance the time at which projects plan to come forward for the C&F regime. This would help to guard against challenges associated with unpredictable resourcing requirements.

Emphasis on operability

Related to the above, Ofgem’s working papers place greater emphasis on system operability and network cost impacts, which suggests an intention to refine the CBA methodology that is used to assess projects to place greater focus on the impact that projects have on the GB transmission system. We consider that, to the extent that system operability and network costs impact directly on consumers, they may be included as part of a **holistic and balanced** assessment framework (and not constitute a threshold criterion). However, taken together, the potential for an increased role for NG ESO and the emphasis that appears to be placed on operability raise significant concerns that the impacts on operation of the system will be significantly over-weighted relative to the wider socio-economic impacts of additional interconnection.

National Grid explains in the recent Future Energy Scenarios (“FES”) report that the GB electricity transmission system is undergoing a period of significant change that is likely to intensify as the UK’s energy strategy pivots towards meeting Net Zero decarbonisation targets. There are certain legacy elements of the existing design of the transmission system that have been in place for several decades (generation in the North, consumption in the South), which affect not only interconnectors but also other market participants. Ofgem’s proposal to make system operability a material factor in C&F assessments (and the lack of transparency around how interconnectors’ contribution to system operability will be assessed) will penalise those projects that might in fact help the grid to adapt to such upcoming challenges, while incentivising projects that fit in better with the status quo.

It is a very probable situation that a project that is more acceptable to NG ESO from the grid operability standpoint may not deliver as much social economic welfare benefits as a project that is less favourable from the system operability standpoint. The results of the AFRY report, where some sort of the system cost optimization methodology was applied resulted in proposing excessive interconnection capacity to Belgium and SEM.

In addition, NG ESO typically implements a “least-regrets” method of assessment, which is based on the most conservative assumptions and, effectively, selects only those developments and projects, which have the lowest downside potential in the most adverse scenario. Accordingly, such approach is more likely to lead to a decision not to take an action.

Finally, interconnectors wishing to connect to the transmission system managed by National Grid, need to undergo feasibility studies and CION assessments, which take into account operability issues, propose relevant limitations on the operation of such interconnectors as well as contributions towards a part of socialised grid improvements costs.

Eligibility criteria

Ofgem considers there is merit in reviewing existing eligibility criteria for the C&F regime and exploring the potential to raise the “maturity threshold” for future projects to create greater

certainty that projects awarded the C&F regime will progress through to completion. Indeed, Ofgem has suggested that developers could be asked to provide “*more substantial evidence*” that their project is being actively considered in the connecting country and that there is a clear and well-defined route to market.¹⁴

We recognise the challenges associated with projects with C&F approval not progressing through to completion, and support an assessment of potential options to remedy this.

However, it is challenging to comment on Ofgem’s proposal without further detail regarding the type of eligibility criteria that Ofgem might be considering. It is also unclear to us how a suitable criterion would be defined *a priori* in a way that does not disadvantage projects that may appear less advanced or favour projects that have strong links to national TSOs. We are concerned that an ill-defined criterion could be used to “pick winners” and hinder participation from a wide range of market participants. We agree with Ofgem’s assessment that strict eligibility criteria at the IPA stage would likely discourage potentially beneficial projects from applying for the C&F regime.

We also caution Ofgem against using engagement with connecting NRAs (or, indeed, PCI status) as a maturity threshold, as neighbouring NRAs are likely to expect Ofgem to take the lead on regulatory approvals before investing time and resource into considering their own regulatory position. This is because neighbouring systems on the continent typically benefit from several potential interconnector options to countries with whom they share a land border. They are also potentially less dependent on interconnection with GB given that they are part of a much larger, synchronous AC system. Finally, interconnection with GB can present unique challenges, including a less consistent regulatory regime and transitional arrangements. For these reasons, neighbouring NRAs may defer regulatory decisions until they have a sense of direction of travel from Ofgem, and requiring regulatory approval from connecting NRAs would therefore leave developers with no viable route to market. It therefore does not represent a suitable eligibility criterion.

Furthermore, using engagement with connecting NRAs as a suitable eligibility criterion may disadvantage projects that are still seeking such approval, but have completed other development activities and may be closer to starting construction.

We also note that, in hindsight, several Window 1 and Window 2 projects that appeared to have active support in their connecting countries and a clear route to market are now faced with significant challenges in part due to the complexities associated with agreeing appropriate transition arrangements. At the same time, some projects that may have been considered speculative at the start are now at a relatively mature stage of their development. This further illustrates the challenges associated with setting suitable eligibility criteria *a priori*.

We are confident that it is not Ofgem’s intention to set an internal rate of return (“**IRR**”) threshold as a potential eligibility criterion. We firmly believe that this type of approach would be entirely inconsistent with the developer-led principle of the C&F regime and Ofgem’s statutory objective to act in the interests of energy consumers.

Overall, we would therefore encourage Ofgem to apply caution in developing any new “maturity criteria”. Ultimately, Ofgem should seek to identify those interconnection projects that maximise benefits to consumers. We therefore recommend that Ofgem also considers the merits of developing

¹⁴ See page 32 of Working Paper 1 of the interconnector policy review (found [here](#)).

alternative approaches that would improve Ofgem’s ability to “check in” and monitor the progress of projects that have been granted IPA. Indeed, Ofgem might consider the merits of introducing a “sunset clause” on original IPA decisions or request developers to renew their IPA submission in the event of significant delays. Any eventual approach would, however, need to be holistic and consider the individual circumstances of each project and the overall commitment of the promoter.

In any case, Ofgem would need to ensure that the introduction of any new eligibility criteria (or checks) does not disadvantage projects applying in the future relative to the projects that were granted IPA decisions in the previous windows, but have not yet progressed to FPA stage. Should Ofgem decide to revise the eligibility requirements for the C&F regime or implement a maturity threshold, we believe that earlier IPA decisions in respect of those projects that have not reached FPA stage should be reviewed based on such new criteria. Creating a stronger test for new projects and not reviewing previous decisions would be inconsistent and breach rules around equal treatment. Strict eligibility criteria could also hinder other aspects of project development, as set out by Ofgem in the consultation document.

Regime timelines

We agree that there is a need for some flexibility in terms of the setting of the commissioning date and RSD-related provisions, and a need to provide relief for delays due to force majeure and other unexpected events, based on a transparent and well-understood set of principles. However, this should not enable projects that are unlikely to progress through to completion from hindering the ability of new projects from entering the regime.

Separately, we also consider that IPA stage review should be completed more promptly than in the past, to protect consumers from undue delays.

Question 6: Do you agree with our initial proposals with respect to potential improvement to parts of the technical design of the cap and floor regime?

We have considered Ofgem’s initial proposals in relation to the C&F regime. We set out our comments on the proposed changes to different aspects of the technical design of the C&F regime in turn below.

Financing rates

We support Ofgem’s decision to review the methodology used to set the interest during construction (“IDC”) C&F rates. We believe that there should be consistency across price controls on certain generic parameters such as total market return. However, any change to the methodology should still reflect the difference in risk and incentives faced by interconnector developers relative to other price controls such as those for onshore networks.

Corporation tax and capital allowance rates

We welcome Ofgem’s decision to review how ongoing changes in the level of corporation tax and capital allowance rates could be reflected in setting the cap and the floor. We believe that developers

should bear tax risk in line with what is observed for onshore networks under the RIIO price controls, as we see no reason for the level of tax risk borne by licensees to vary across regulatory regimes.

Question 7: Do you have any suggestions for ways in which any potential future regime could work better for a broad range of developers?

We are of the view that a developer-led approach with ongoing access to the C&F regime – as envisaged under Option 1 – would attract and be workable for the greatest range of potential developers.

As described in our response to Question 2 and Question 4 above, we believe the existing C&F regime has been more favourable to TSO developers such as National Grid who follow a corporate finance or balance sheet approach to financing interconnectors (while developers who follow a project finance approach to financing interconnectors have been disadvantaged).

We view the proposed changes to the C&F regime to accommodate project finance developers for NeuConnect and Greenlink as positive developments. We believe that these proposed changes should form the basis of a project finance version of the C&F regime, with developers having the option to pursue a corporate finance or project finance version of the C&F regime.

We would like to refer you to an independent report produced in 2019 in Confidential Appendix 2, which has also been provided to Ofgem earlier. The report is based on the feedback from a number of equity infrastructure investors and project finance banks.

Some of those variations have been addressed in the variations of the cap and floor regime granted to NeuConnect and GreenLink. However, all items need to be considered as possible elements of project finance-based cap and floor regime based on specific project needs.

It is likely that project finance developers will have bespoke needs and require greater flexibility within the regulated regime that is not available within the default approach. Therefore, Ofgem should retain some form of flexibility within the default regime going forward.

We welcome Ofgem's acknowledgement of potential issues with FPA/FID circularity and Opex uncertainty at the FPA stage. We believe these issues could be solved by Ofgem providing a form of commitment such as a letter of intent that finance rates and allowances will not be fixed until reaching FID. This would provide greater certainty to lenders. Ofgem can also proactively engage with lenders to alleviate any concerns regarding the fixing of allowances before FID.

We have considered further improvements to the C&F regime that Ofgem could make to aid project finance developers reaching financial close. Another, potential improvement could be to allow developers to 'cash flow during construction' i.e. a revenue stream is earned during the construction phase. This would allow developers to service any debt raised during the construction phase. This approach has been used for other standalone infrastructure projects, such as the Thames Tideway Tunnel.¹⁵

¹⁵ See Thames Tideway Tunnel's licence [here](#) for more details.

We also view it as critical that, under the project finance approach, all efficiently incurred costs are considered by Ofgem. This includes costs such as setting up debt service accounts, legal fees, and financing fees.

We have reviewed Ofgem's proposed changes to the C&F regime for NeuConnect and Greenlink.¹⁶ We are concerned that the project finance developers are in fact being penalised for greater transparency. For example, under the current proposals, it appears project finance developers will receive the floor for only 22 years (calculated by combining the length of senior debt and the debt tailing phase), whereas corporate finance developers will receive the floor for 25 years.¹⁷ This suggests a loss in downside protection for project finance developers as the total protection offered is lower for project finance developers than for corporate finance developers (or, to be more specific, National Grid).¹⁸

We note this loss in downside protection has not resulted in a commensurate change in the potential upside (represented by the cap) for project finance developers as the cap is the same for both project finance and corporate finance developers. If project finance developers are going to receive fewer years of and less protection than their corporate finance counterparts, it appears appropriate to reflect this by allowing project finance developers to be allowed to keep more of the upside as they require less downside protection from consumers.

Question 8: Are there any other potential regime improvements that we should explore that are not considered in this section?

In our view, one feature that would be helpful to include in any future C&F regime is the ability for projects to be able to flex the share of the asset that would be governed by the C&F regime and consider a wider range of solutions than a 50:50 split. Potential splits should be informed by the benefits case for each project, the costs of the project within each country and other relevant factors. For example, construction and operational costs in the UK are typically higher than in some neighbouring countries. Such decisions need to be based on the facts and circumstances of specific projects rather than by applying the same template in each case.

Section 5

Question 9: Do you agree with our conclusions? If not, please concisely explain why and provide supporting information if available.

¹⁶ For more detail see the decision letter [here](#).

¹⁷ It appears that, using the C&F financial model provided, project finance developers will receive a lower floor than those developers under corporate finance. We acknowledge this may change by the times the cap and floor are locked in during the PCR.

¹⁸ This is calculated by multiplying the floor times number of years of the floor. Assuming the same floor applies to both project finance and corporate finance developers this would be the case. As described in the footnote above, currently project finance developers receive a lower floor than their corporate finance counterparts, suggesting a compounding effect of lower protection.

We agree that the C&F regime has been an important mechanism for incentivising the development of further GB interconnection capacity since its introduction in 2013/2014. We consider that the C&F regime is based on sound economic principles and offers a good framework for attracting new interconnector investment from a wide range of developers.

However, we do not agree that there is a need for a more centralised approach to application windows informed by a more enhanced role for NG ESO. We consider that Ofgem's proposals in this respect represent a marked shift away from the 'developer led' principle of the C&F regime, which has been fundamental to the success of the C&F to date. While we do not believe it is Ofgem's intention, we are concerned that the proposals will reduce investor confidence, narrow the potential pool of third-party investors, and lead to a 're-centralisation' of interconnector development.

Question 10: Do you agree with our initial proposals? If not, please concisely explain why and provide supporting information if available.

We recognise that the needs case for further interconnection is now more closely linked to the UK's decarbonisation agenda than previously. However, we do not agree that this necessitates a more centralised approach to application windows informed by a more enhanced role for NG ESO. We are concerned that a more proactive role for NG ESO would lead to system operability being disproportionately prioritised in future assessments relative to the wider socio-economic impacts of additional interconnection to the detriment of GB consumers.

We are most supportive of ongoing case-by-case applications by mature projects (Option 1) and broadly supportive of cyclical investment rounds with regular application windows that take place at least every two years if not more frequently (Option 4).

We agree with Ofgem's assessment that strict eligibility criteria at the IPA stage would likely discourage potentially beneficial projects from applying for the C&F regime. We therefore encourage Ofgem to apply caution in developing new eligibility criteria and recommend that Ofgem also considers the merits of developing alternative approaches that would improve Ofgem's ability to "check in" and monitor the progress of projects that have been granted IPA. In any case, Ofgem would need to ensure that the introduction of any new eligibility criteria (or checks) does not disadvantage projects applying in the future relative to projects that applied to earlier windows.

Other

Question 11: Do you have any further feedback on our analysis, conclusions or proposals presented in this consultation document?

We have no further comments on the analysis, conclusions and proposals set out in Working Paper 1.

