CIP

COPENHAGEN INFRASTRUCTURE PARTNERS

Response to the Interconnector Policy Review: Workstream 1 Consultation

1 INTRODUCTION AND SUMMARY

1.1 Copenhagen Infrastructure Partners (**"CIP"**) welcomes the opportunity to provide comments in response to Ofgem's consultation on Working Paper 1 of the Interconnector Policy Review, which relates to the cap & floor regime for interconnectors in Great Britain ("**GB**").[1]

1.2 CIP is a fund management company specialising in energy infrastructure investment.[2] We currently manage funds with approximately €16bn of assets under management. We invest globally in assets across the energy supply chain. In the United Kingdom ("**UK**"), we have invested in a number of assets ranging from onshore wind (Borea portfolio) to offshore wind (Beatrice offshore wind farm) and from energy-from-waste (Lostock and Slough) to biomass power plants (Templeborough, Kent, Brigg and Snetterton). We have been investing in transmission assets (primarily connecting offshore wind farms located in the German North Sea) and continue to explore investment opportunities that will expand our footprint in transmission assets in Europe. In this context, we are actively evaluating potential interconnection opportunities between Great Britain ("**GB**") and European markets.

1.3 As Ofgem is aware, electricity interconnectors are cross-border transmission links that enable electricity to flow between two regions. Interconnectors allow low-cost electricity to be exported to neighbouring markets with higher prices and help to reduce prices and customer bills in the importing market. Interconnectors also support the decarbonisation agenda by allowing for better and more efficient management of intermittent renewable generation, and boost security of supply by providing access to additional generation capacity located in a neighbouring country, usually characterised by a different power mix and/or with different resources, thus providing resilience and diversification.

1.4 The cap and floor regime in GB was first implemented in 2013/2014 to incentivise further interconnection, and encouraged developers to bring forward a range of projects to the market by helping to manage risk while retaining commercial incentives. There are currently four projects under construction or already operational between GB and its European neighbours that have benefitted from the provisions of the cap and floor regime (Nemo Link, IFA2, NSL and Viking Link), compared to only one project that is proceeding using the exemption route (ElecLink).[3]

---

[1] Ofgem, Interconnector Policy Review: Working Paper 1 – Review of the cap and floor regime, 18 June 2021, (link).
[2] For more information on CIP, please see our website for more detail.
[3] See Ofgem, Interconnector Policy Review: Working Paper 1, Table 2.

1.5 A key strength of the cap and floor regime has been the developer-led approach. This has allowed projects to draw upon a wide pool of technical expertise and capability, and supported the emergence of alternative financing structures and promoted innovation. The regime has generated significant interest among a group of specialist developers and has created the opportunity for investors to invest in projects that seek to deliver significant benefits in terms of consumer welfare.

1.6 It should be noted, however, that several projects have failed to progress their development from Initial Project Assessment ("**IPA**") through to delivery and the cap and floor regime has not been able to deliver the expected level of operational interconnection within the anticipated timelines. In addition, all the projects that have been completed successfully have been promoted by the national transmission system operator ("**TSO**") in GB, while projects promoted by third-party developers are not expected to become operational before 2024/2025 at the very earliest.

1.7 We consider that the current review therefore presents an opportunity to assess the strengths and weaknesses of the existing regime, and identify potential improvements to ensure that it continues to provide a "level playing field" for different types of developers and investors, while at the same time delivering benefits to energy consumers. This will be especially important in the context of a transitioning energy system, where the share of power produced from intermittent renewable sources (in particular offshore wind and to a lesser extent onshore wind) is expected to increase dramatically in the period to 2050 to support the government's decarbonisation agenda and the legal requirement to achieve Net Zero by 2050.[4]

1.8 It is in this context that we provide our comments in response to Ofgem's initial findings and proposed recommendations in Working Paper 1. Our main points are as follows:

- First, Ofgem should take this opportunity to consider the reasons why several promising projects promoted by independent developers have not been able to progress from IPA stage to delivery as anticipated, and seek to identify ways to reduce the risk of this happening again going forward. One potential mitigation might be to require promoters to provide an initial letter of intent from the counterparty regulator as part of meeting the eligibility criteria for the cap and floor regime.

- Second, Ofgem should retain the developer-led approach for identifying future sources of interconnection. This allows Ofgem to draw on the wide range of expertise, experience and data from the private sector ensuring that the best projects for consumers are identified. A more centralised approach relying on analysis from National Grid Electricity System

[4] Department for Business, Energy & Industrial Strategy, UK becomes first major economy to pass net zero emissions law, 27 June 2019, (link).

Operator ("**NGESO**") – such as the one submitted for consultation by Ofgem[5] – risks failing, by not tapping into all information, experience, and expertise available, to identify those interconnection opportunities that maximise consumer benefits. Therefore, we view Option 4 (cyclical investment rounds) as most appropriate for identifying optimal interconnection opportunities in future application windows.

- Third, we welcome Ofgem's commitment to ensuring a level playing field between different types of interconnector developers. We view Ofgem's flexibility in accepting the changes proposed to the cap and floor regime by the promoters of the NeuConnect and Greenlink projects[6] as positive developments and consider that Ofgem should retain this flexibility when considering well substantiated proposals to the cap and floor regime put forward by market participants in the future.

- Finally, Ofgem should take this opportunity to consider the role of interconnectors in the context of a transitioning energy system. Ofgem should provide greater clarity on how it intends to balance socio-economic benefits with the range of wider benefits provided by interconnectors when determining whether to award the cap and floor. It should also ensure that the cap and floor regime provides incentives that reward interconnectors' contribution to wider system benefits fully.[7] Ofgem has already recognised concerns that the floor does not provide full protection of equity investment,[8] which may prevent projects that generate positive consumer welfare and wider benefits from being able to attract the required capital if they only earn the floor in the early years of operation. This would likely result in a higher cost of capital for developers, reducing the potential number of interconnectors and consumer welfare. Ofgem should therefore consider, as part of Workstream 1, whether projects at the floor earn a sufficient return to remain financeable and whether the contribution of interconnectors to wider system benefits is reflected fully in the incentives provided by the regime.

1.9 In the remainder of this response, we respond to the individual consultation questions raised in Working Paper 1 on the cap and floor regime.

[5] Ofgem, Interconnector Policy Review: Working Paper 1 – Review of the cap and floor regime, 18 June 2021, p.6, (link).
[6] Ofgem, Decision on proposed changes to the electricity interconnector licences held by Greenlink Interconnector Limited and NeuConnect Britain Limited, 18 June 2021, (link).
[7] While interconnectors are rewarded for the capacity they sell and the ancillary services they provide, it is unclear if this corresponds to their full contribution to wider system benefits.
[8] See Ofgem, Interconnector Policy Review: Working Paper 1, page 42: Floor to cover minimum equity return, (link).

2 RESPONSE TO CONSULTATION QUESTIONS

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

2.1 We agree that Ofgem's approach for workstream 1 seems appropriate for considering what amendments could be made to the cap and floor regime to ensure GB consumers benefit from increased interconnection. The Interconnector Policy Review presents an opportunity to reflect on what has worked well under the cap and floor regime and what could be improved.

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

2.2 We consider that the developer-led approach has been a key strength of the cap and floor regime for Window 1 and Window 2, and has enabled Ofgem to draw on the expertise and experience of a wide range of developers in identifying possible sources of interconnection. The developer-led approach has fostered innovation and competition in the provision of cross-border capacity, as evidenced by the wide range of promoters that applied for the cap and floor regime during Window 1 and Window 2, and those who continue to seek access to the regime.

2.3 The developer-led approach also allows Ofgem to benefit from information on the costs associated with each investment and the technical engineering requirements for each project that it would not otherwise have access to. For example, when conducting Network Options Assessments ("**NOA**")[9] on required future interconnection for GB, NGESO must rely on publicly available information on construction costs, and assumes no Opex due to the uncertainty associated with these costs.[10] These costs may not reflect the actual cost associated with each option, and the "centralised" approach risks potentially leading to NGESO omitting interconnection opportunities that maximise GB consumer welfare from its analysis. However, a developer-led approach alleviates this information asymmetry, and enables Ofgem to identify the best opportunities. This is a further key strength of the developer-led approach.

2.4 We do not agree fully with Ofgem's assessment that the current assessment framework is a weakness. We acknowledge that some aspects could be improved to ensure that interconnection capacity is delivered as intended. However, the transparency and flexibility associated with the current regime also allows non-transmission system operators (**"non-TSOs"**) to compete with existing TSOs when putting forward potential projects. We encourage Ofgem to ensure that this remains the case following any proposed changes to the assessment framework under the cap and floor regime, as doing otherwise would reduce the value created by the competitive process

[9] The Network Options Assessment is the process that NGESO goes through annually to understand the reinforcement projects required to deliver the expected demand over the coming years.
[10] National Grid ESO, Network Options Assessment, January 2021, p.80, (link).

and discourage developers from putting forward projects that could be beneficial to GB consumers.

2.5 As part of the review of the cap and floor regime, we believe that Ofgem should take the opportunity to review the reasons why certain projects that have been granted a cap and floor at the IPA stage have not been able to progress further as anticipated. Understanding why this has been the case and identifying any common themes would allow Ofgem and to address any potential weaknesses of the current eligibility criteria, and to tailor the eligibility criteria for the cap and floor regime so that similar delays can be avoided in the future.

2.6 Further, Ofgem should also take this opportunity to review its approach to reporting the headline amount of expected future interconnection capacity under the cap and floor regime (currently estimated at 10.9GW) to account for projects which may no longer go ahead or be significantly delayed. This should also be reflected in any analysis performed when determining the amount of future interconnection required.

2.7 By taking account of projects that are unlikely to progress, Ofgem will be able to avoid a false sense of security and will also ensure that the cap and floor regime is not "saturated" with projects that realistically will not progress. This will ensure the cap and floor process is not "crowded out" for future developers promoting new interconnection capacity and that GB consumers can indeed benefit from the promised capacity.

2.8 The review into the cap and floor regime also presents an opportunity to consider the role of interconnectors in the context of a transitioning energy system. While interconnectors help to lower customer bills, they also help to reduce carbon emissions, provide flexibility, and ensure security of supply. We recognise that Ofgem is considering how to value the wider benefits of interconnectors as part of Working Paper 3. As part of this workstream, Ofgem should seek to provide greater clarity on how it intends to balance socio-economic benefits with the wider benefits provided by interconnectors as part of its assessment process.

2.9 In our view, Ofgem should also consider, as part of Working Paper 1, whether any further regime amendments would be appropriate to ensure that the cap and floor regime rewards interconnectors' contribution to wider system benefits fully.[11]

2.10 The UK's departure from the European Union ("**EU**") poses challenges that go beyond issues such as potential regulatory divergence and efficiency of trade. Brexit creates uncertainty for investors due to the increased political risk introduced through the separation agreements. For example, the Trade and Cooperation Agreement ("**TCA**") between the UK and the EU ensures

[11] While interconnectors are rewarded for the capacity they sell and the ancillary services they provide, it is unclear if this corresponds to their full contribution to wider system benefits.

secured and continued access to the EU energy market for the UK until 30 June 2026.[12] However, there is still uncertainty about what the arrangement will look like beyond this period. This is pertinent for interconnectors given their reliance on cross-border trade and the long development timelines (as highlighted by all projects that have participated in Window 1 and Window 2).

2.11 This increase in political risk will likely result in a higher cost of capital for interconnector developers and could affect the ability to make the project financeable. This may reduce the amount of interconnection capacity, resulting in lower benefits for consumers. We believe Ofgem, working closely with the UK Government and its counterparties in the connecting countries, should seek to reduce this threat where possible.

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?

2.12 We agree that the cap and floor regime has been successful in terms of granting a licence to nine interconnector projects with a combined capacity of 10.9GW. If all these projects were to go ahead, GB interconnection capacity would increase from its current level of 4GW to 15.9GW.[13] The regime's objective of providing confidence to investors (debt and equity) on the level of return that they can expect to earn is currently being tested by the first projects developed on a project finance basis approaching their financial close, which would be an important milestone for the cap and floor regime, demonstrating that developers are able to attract the required capital, while also retaining commercial incentives and providing benefits to consumers through lower energy prices and payments when licensee revenues are above the cap (in addition to wider benefits).

2.13 The fact that out of the 10.9GW capacity granted a licence under the cap and floor regime, only 3.4GW is expected to be operational by the end of 2021[14] illustrates the challenges associated with converting interconnector capacity that has been granted a licence under the cap and floor regime into a fully operational project. In addition, it has taken significantly longer than originally expected for all developers (TSOs and non-TSOs alike) to deliver the planned capacity.

2.14 Furthermore, there is currently no mechanism for removing those projects which have been granted a cap and floor licence at IPA but are falling significantly behind their expected progress (as adjusted for unforeseen circumstances and/or force majeure) or look unlikely to progress at all. Ofgem should look to remove those projects which have previously been granted a licence

[12] UK government, TRADE AND COOPERATION AGREEMENT between the European Union and the European Atomic Energy Community, of the one part, and the United Kingdom of Great Britain and Northern Ireland, of the other part, 24 December 2020, p.172 (link).
[13] ElecLink (a 1GW interconnector between GB and France) will not be regulated under the cap and floor regime.
[14] The three cap and floor regime interconnector projects expected to be fully operational by the end of 2021 are Nemo Link (1GW), IFA2 (1GW) and North Sea Link (1.4GW).

but are unlikely to progress, reducing the potential to "crowd out" future developers, or, at least, not consider them when determining GB's requirement for incremental interconnection capacity.

2.15 Additionally, so far, all projects that have become operational under the cap and floor regime to date have been developed and are operated by National Grid Ventures, the unregulated TSO business of the GB TSO. This suggests that non-TSO developers may face challenges with delivering projects under the cap and floor regime. We note that Ofgem has considered improvements to the cap and floor regime to aide with the delivery of projects for NeuConnect and Greenlink (which are understood to be due to reach financial close in 2021).[15] We welcome Ofgem's decision to approve these changes and consider that Ofgem should continue to ensure a level playing field between different types of developers (TSO and non-TSO, balance sheet and project finance) for delivering projects under the cap and floor regime.

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?

2.16 We agree that the five high-level principles underpinning the cap and floor regime as stated in 2011 remain fit for purpose.[16] These five principles appear reasonable and remain appropriate for current and future investors, developers, and consumers.

2.17 However, not all of these principles have been met fully. For example, one of the key principles underpinning the regime was a coordination on regulatory treatment of developers between National Regulatory Authorities ("**NRAs**"). More work is required to harmonise the views and coordinate the actions across regulators, thus ensuring consistent messages for developers.

2.18 Additionally, while the regulatory treatment under the cap and floor regime has allowed for non-TSO and TSO developers to compete during the IPA stage, only TSO-developed interconnectors have reached the final stage of the cap and floor process, i.e. the post-construction review ("**PCR**"). This suggests that amendments to the cap and floor regime such as those suggested for Greenlink and NeuConnect (two interconnectors developed by non-TSO developers) should be retained going forward to ensure that non-TSO developers have a level playing field with TSO developers.

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:

[15] Ofgem, Decision on proposed changes to the electricity interconnector licences held by Greenlink Interconnector Limited and NeuConnect Britain Limited, 18 June 2021, (link).
[16] See Ofgem, Preliminary conclusions on the regulatory regime for project NEMO and future subsea electricity interconnector investment, 20 December 2011, p.1 (link).

a) To consider a more coordinated and system-wide approach to application windows, potentially informed by a more proactive role for NGESO. 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?

2.19 We have reviewed the three points raised by Ofgem with respect to potential changes to the assessment framework. We set out our views on each of these points in turn below.

(a) Application windows

2.20 We do not agree with the proposal for a more "system wide" approach to application windows or a more "proactive" role for NGESO in determining the focus of future windows. We believe that this type of approach would contradict the developer-led model that is a key principle and strength of the cap and floor regime. We believe that a more "coordinated" model would have an adverse impact on the level of innovation and competition in the provision of cross-border transmission infrastructure.

2.21 As a result, we do not consider Option 1 (case-by-case applications), Option 2 (pre-determined window with a pre-determined capacity level) or Option 3 (pre-determined window with a pre-determined geographical scope) to represent an appropriate way forward. This is for the following reasons.

2.22 First, case-by-case applications would make it more difficult for Ofgem to undertake comparative assessments of projects. The window-based approach allows Ofgem to compare contemporaneous projects across developers, which helps to choose those projects that benefit consumers the most. If Ofgem moves to case-by-case assessments, it would have to rely on a significant number of developers to apply at the same time or to use historic comparisons in assessing projects, which may not reflect latest technological developments.[17] As a result, Ofgem may find it difficult to assess whether projects create benefits for GB consumers or, indeed, overstate their benefits.

2.23 A case-by-case approach may also favour those developers who are more mature in the development process and able to apply sooner, even though their projects may deliver significantly lower benefits compared to projects that are somewhat earlier in the development

[17] Comparing historic projects with contemporaneous projects is difficult due to the different sources of information available at the time the project was applied for. For example, the technology available to the developer and market conditions may have changed over time. This could result in a complicated process for Ofgem to assess historic and contemporaneous projects.

phase. Such a situation may not maximise consumer welfare, and a case-by-case approach would therefore unfairly penalise those projects that are less mature but provide greater consumer welfare benefits. A window-based approach standardises the application process allowing all eligible projects to set their case on a level playing field, thus generating a competitive tension for delivering consumer benefits rather than a rush to be "first in line" to be considered. Therefore, we consider a window approach helps to solve both of these issues highlighted above.

2.24 Second, the centrally planned options (i.e. Options 2 and 3) appear to be inferior to a developer-led approach. As set out in our response to Question 2 above, this is because developers may identify different opportunities, have access to better data and/or make use of different expertise and experience than central planners such as NGESO. This difference in approach could have a material impact on the amount of consumer welfare benefit delivered by the interconnection delivered for GB consumers.

2.25 Further, NGESO's forecast for the location and required level of interconnection has changed over time as part of the NOA. To take a recent example, in 2020, NGESO forecast GB required 18-23GW of interconnection capacity but in 2021 this forecast had changed to 17-28GW.[18] At the lower end of the range, this would be just 1.1GW above the current capacity that has been granted a licence under the cap and floor regime, potentially implying that just one additional interconnector may be needed. We believe that the sector requires clearer guidance.

2.26 The variance in the NGESO's forecasts could lead to very different outcomes depending on the year in which the analysis is performed and the sensitivity of NGESO's forecasts to underlying assumptions. This uncertainty could be disruptive to developers, potentially increasing the cost of capital faced by developers and ultimately consumers, who have this cost passed on through higher energy prices.

2.27 Instead, it would be more appropriate to rely on developers who will naturally have to take a longer-term view due to the long project life of interconnectors, typically at least 30 years (including both construction and operation phases). A developer-led approach would also help to alleviate any information asymmetry associated with the cost, benefits, and challenges of each interconnection option.

2.28 As a result, it is our view that Option 4 (i.e. cyclical investment rounds) is the best approach for application windows. This retains the developer-led approach that addresses any issues associated with lack of information, experience and expertise associated with a particular project between the central planner and developers, and ensures that Ofgem can compare contemporaneous projects with each other.

[18] National Grid ESO, Network Options Assessment, January 2020, p.63 (link); National Grid ESO, Network Options Assessment, January 2021, p.83, (link).

2.29 We also note that similar approaches exist in Continental Europe. For example in Germany, every two years, developers (including TSOs and non-TSOs) have the opportunity to apply for projects to be part of the offshore and onshore grid development plans.[19] If approved to be part of these plans by the German energy regulator, Bundesnetzagentur, then it is assumed that these projects will proceed and receive the necessary regulatory approvals.

2.30 Another advantage of having a cyclical investment round is that it provides predictability for developers. This enables developers and other market participants to plan and produce more developed delivery and business plans than in the case of an ad-hoc window or a first-come-first-served approach.

2.31 We acknowledge that Ofgem will need to balance how long and how frequent the windows will be open. This is to ensure that Ofgem has sufficient capability to assess all plans submitted. For example, an investment round that takes place twice a year will most likely be too frequent and so a window that takes place annually or even every two years may be more appropriate to allow for better planning by both Ofgem and developers.

(b) Eligibility criteria

2.32 We agree that the eligibility criteria should be included as part of the current review to ensure that a greater share of projects progress successfully from IPA to PCR going forward. However, we disagree that an increase in the maturity threshold is required as it may disincentivise those projects which provide greater consumer benefits but are less mature than their counterpart projects.

2.33 Any change in the eligibility criteria needs to be considered carefully to avoid or mitigate any adverse consequences. For example, allowing NGESO to design the eligibility criteria, as suggested by Ofgem, may prioritise criteria that are more relevant to TSO developers to the potential detriment of criteria specific to, and required by, non-TSO developers. This may create an uneven playing field for TSO and non-TSO developers which may not be in the best interest for GB consumers, as it restricts the number of viable projects available to them. Similarly, there is a risk that NGESO might place more emphasis on criteria that support its operational objectives (such as ensuring system operability) without pursuing a more holistic approach that falls outside its immediate direct remit.

2.34 With respect to changes in the maturity threshold, an alternative solution might be to require developers to provide additional information to demonstrate the connecting NRA's support for, or acceptance of, a project. This information could be in the form of an initial letter of intent from the counterparty regulator confirming that the project is eligible for participating in the relevant process

[19] See Bundesnetzagentur, Bundesnetzagentur and grid expansion, (link) for more information.

in the connecting country and, subject to meeting certain criteria, eligible to receive a licence. Alternatively, the developers should present a credible plan for the delivery of the project. Such additional information would allow Ofgem to assess the credibility of developers' plans and approve projects that are likely to progress to completion. This should provide an additional source of comfort to Ofgem that projects granted a licence at IPA stage will proceed as expected.

(c) Regime timelines

2.35 We agree with Ofgem that amendments to the current incentive mechanism for ensuring timely delivery of projects are likely to be helpful. A possible additional incentive mechanism might be to assess the project against a delivery plan provided by developers at the IPA stage (as suggested above in our response on eligibility criteria). If timelines slip materially against the envisaged delivery plan, then adjustments could be made, as further described below.

2.36 Any such adjustments should take in account events that are clearly outside of developer control, such as adverse weather conditions or a pandemic. These events would need to be carefully defined in any adjustment mechanism to provide certainty and clarity to developers. As part of this assessment process, we suggest the developer would need to update Ofgem annually and at key project milestones, i.e. when the project is 50% complete or the beginning of the construction phase.

2.37 Ofgem should also consider how changes in regulatory policy, taxation and government may impact a project's development and timelines. These factors should be considered both as part of the IPA and as the ongoing process as the projects move from IPA to PCR.

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?

2.38 We have reviewed Ofgem's proposals with respect to changes in technical design. Our thoughts on these issues are as follows.

Financing rates

2.39 Our view is that the alignment of generic parameters (i.e. those parameters which should not change across company or sector such as total market return and the risk-free rate) is appropriate and we support Ofgem in ensuring consistency across onshore and offshore regulatory regimes. However, we believe any change in methodology to the financing rates (such as the interest during construction rate, cap rate and floor rate) should still reflect the difference in risk and incentives faced by interconnector developers as compared to onshore networks under RIIO.

Corporation tax and capital allowance rates

2.40 We support Ofgem's decision to review how changes in the level of corporation tax and capital allowances could affect the cap and floor following the Financial Investment Decision ("**FID**"). Our view is that there should be a consistent policy on who bears tax risk across regulatory regimes, and that developers should bear a level of tax risk in line with companies who are regulated under the onshore price controls (i.e. RIIO).

2.41 We suggest that any updates to the cap and floor to reflect changes in tax policy of the UK Government could be undertaken at the same time as the Annual Iteration Process for RIIO. This would ensure consistency across regulatory regimes and increase efficiency for Ofgem as it removes the potential duplication of tasks.

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

2.42 We support Ofgem's commitment to ensuring that the cap and floor regime provides a level playing field for a range of developers, e.g. for non-TSO and TSO developers and those who follow either corporate finance or project finance approaches to financing projects. Our view is that Ofgem's decision to approve the changes to the cap and floor regime proposed by NeuConnect and Greenlink is a positive development and should be retained going forward to ensure a level playing field for corporate financed and project financed assets.

2.43 In addition, we are supportive of Ofgem retaining the flexibility to make further changes to the cap and floor regime in response to well substantiated proposals from market participants. In particular, it is likely that developers who follow a project finance structure will need more bespoke solutions due to the individual nature of each project and the ever-changing nature of the financing markets and the requirements imposed by the lending banks.

2.44 With regards to other issues cited by other stakeholders, such as FPA/FID circularity and Opex uncertainty,[20] uncertainty could be alleviated by Ofgem through initiatives such as letters of intent and engaging directly with lenders. This provides clarity, allowing projects to be financeable.

2.45 With respect to the floor not providing sufficient return to equity investors,[21] we acknowledge that the floor, provided to the entire capital stack of a project, was designed to ensure that projects could meet their debt obligations and at the same time allows equity investors to earn a return equivalent to the cost of debt. However, based on the recent analysis performed by AFRY on behalf of Ofgem, it appears that most projects are likely to generate revenues close to the floor for the near future (i.e. the first 5-10 years of the project). This will likely result in lower debt financing capacity (as lenders stress test downside scenarios) and a higher cost of equity (as a significantly higher portion of the equity return is predicated on the more uncertain revenues

[20] See Ofgem, Interconnector Policy Review: Working Paper 1, pages 41-42.
[21] See Ofgem, Interconnector Policy Review: Working Paper 1, page 42: Floor to cover minimum equity return.

expected to be generated further in the future). At the same time, interconnectors are delivering wider near-term benefits on the system and to the GB consumer (see 2.45 below), so therefore raising the floor to reflect these benefits would appear appropriate and ensure the financeability of such projects.

2.46 As noted in Working Paper 3, interconnectors have wider impacts on the system beyond the transmission of electricity from one country to another.[22] These impacts include helping with the delivery of Net Zero decarbonisation targets, providing system flexibility and resilience, and ensuring system operability and security of supply. Currently, interconnectors are remunerated for the capacity they sell and the ancillary services that they provide; however, it is unclear if this corresponds to their full contribution to wider system benefits.

2.47 We acknowledge that some of these impacts are difficult to value, but some can be quantified. For example, sufficient interconnection capacity reduces the need for providing incentives for back-up / peaking power generation capacity, which usually is provided from sources with higher carbon intensity. The avoided cost related to such capacity, which otherwise would need to be passed on to GB consumers, would be a direct benefit of increased interconnection capacity and should be recognised and quantified as such. Ofgem could recognise these and other benefits interconnectors bring to the system by either (a) raising the floor for developers who consider these impacts in their submissions to Ofgem, or (b) including a suite of incentives to encourage interconnectors to consider the wider impact of their actions. These incentives and/or raising the floor would need to be carefully calibrated.[23]

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

2.48 Ofgem should take this opportunity to consider whether projects should be able to adjust the proportion of the asset governed by the cap and floor regime. Currently, assets are assumed to be governed equally by both the cap and floor regime and the regime of the other NRA. It could be beneficial for consumers to have a different assumed split on a project-by-project basis. Our view is the assumed split could be governed by each project's benefits case.

2.49 In addition, as described in our response to Question 5, we consider Ofgem should adjust the eligibility criteria to include a letter of intent from the counterparty NRA. This would allow Ofgem to consider whether the project is likely to be delivered as promised. Regardless of whether this piece of information is provided, we consider it prudent for Ofgem to undertake a qualitative assessment of each project's likelihood of being approved by the counterparty NRA during the

[22] Ofgem, Interconnector policy review: Working Paper 3 – Wider impacts, 30 June 2021, p.5 (link).
[23] The impact of any incentives would need to ensure that licensees are able to their meet debt payments. This may mean that when at the floor, incentive payments cannot go below zero to ensure this holds.

IPA. This will ensure that only projects that are likely to be granted a licence by the counterparty NRA are approved.

2.50 We acknowledge this assessment is likely to be subjective and may require greater engagement with counterparty NRAs. We also recognise that, by the nature of their business, TSO developers are likely to have closer relationships with NRAs and it is important that this does not create an uneven playing field. However, it should ensure that projects which are approved have the greatest chance of progressing to the PCR.

Question 9: Do you agree with our conclusions? Please provide supporting information if available.

2.51 We broadly agree with most of the initial conclusions set out by Ofgem. However, as described in our response to Question 4, we disagree that all of the principles underpinning the cap and floor regime have been delivered to date. We acknowledge and are supportive of the fact that Ofgem is considering putting in place mechanisms to ensure these principles will be met going forward.

Question 10: Do you agree with our initial proposals? Please provide supporting information if available.

2.52 We agree with Ofgem's initial proposals on topics such as regime design. However, as described in our response to Question 5, we believe that the cap and floor regime should retain the developer-led approach, i.e. Option 4 (cyclical investment rounds), rather than rely on NGESO's involvement in identifying the need for new interconnection capacity, i.e. Option 2 (pre-determined window with a pre-determined capacity level) or Option 3 (pre-determined window with a pre-determined geographical scope).

2.53 Our view is based on the developer-led approach allowing Ofgem to draw on the expertise, experience and data available to a broader spectrum of developers which may not otherwise be available to Ofgem (or, indeed, NGESO) in a more restricted assessment and determination process. The more open developer-led process is likely to lead to identifying the interconnection opportunities which benefit consumers the most from a socio-economic perspective and ensure a long-term view is taken.

2.54 We agree that a window approach should be retained given the ability to benchmark contemporaneous projects against one another, thus ensuring benefits to consumers are maximised. Therefore, we believe that (i) Option 1 (case-by-case applications) should not replace the current window-based approach; and (ii) Ofgem should run future windows for interconnection capacity with regular frequency.

2.55 We also suggest that Ofgem should exercise caution when making any changes to the eligibility criteria under the cap and floor regime to ensure no unintended consequences, such as approving only projects put forward by TSO corporate financed projects. This could be detrimental to consumers as it may exclude projects run by non-TSO developers and those who follow alternative financing structures such as project finance. This reduces the choice and availability of potential projects and could result in consumer benefit not being maximised.

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

2.56 We have no further feedback on Ofgem's consultation on Working Paper 1 at this stage.