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## **Interconnector policy review: Working Paper 1 – Review of the cap and floor regime**

Dear IC Policy Review Team,

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

We are broadly in agreement with Ofgem's assessment.

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

We are broadly in agreement with Ofgem's assessment.

### **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?**

We are broadly in agreement with Ofgem's assessment.

### **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?**

Ofgem has worked with developers to optimise the C&F regulatory parameters to incentivise private capital to invest in the interconnector sector. We believe that the scheme could be further optimised to facilitate the project financing of interconnector projects. Several projects are in the market approaching lenders and these will be interesting test cases from which many lessons can be learned, particularly on the coordination of steps leading to final regulatory decisions from NRAs and project finance financial close.

**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?**

**Assessment Framework**

Ofgem's proposal "to shift towards a more coordinated and system-wide approach to application windows may be preferable" is a large shift in policy away from the successful developer-led approach to date. We have the following reservations/comments with regard to a centralised decision making process.

- Ofgem acknowledges that the developer led approach has been successful in securing interconnection capacity. There is an element of "if it ain't broke, don't fix it". We believe Ofgem can introduce certain refinements to the existing regime to stimulate investment over target borders without requiring a *volte face* change in policy.
- NGENSO's input is better achieved through its proactive participation in the C&F consultation process. The decision to invest in further interconnection requires input from a large group of stakeholders with a broad skill set including cross border expertise and raising capital to finance projects.
- NGENSO's and Ofgem's perspective for the need for additional interconnection is necessarily seen through a GB lens, however, this is only half the story. Developers are often better placed to assess the need for a specific interconnector after analysing a broad set of project criteria and following detailed discussions with stakeholders in the connecting country.
- Interconnection is one of National Grid's unregulated businesses. While NGENSO is separate from National Grid Ventures, it retains a common shareholder and geographical location. Until there is full legal separation, developers and consumers will be naturally cautious of potential conflicts that could arise between NGENSO and National Grid Ventures.

Of the options presented, we consider *Option 1: Case by Case Applications* will provide the optimal mechanism to deliver new interconnector capacity. Ofgem's interconnector team has the expertise to appraise projects on a case by case basis and has built up a significant data base of interconnectors on GB's borders on which to evaluate projects. As a fall back *Option 4: Cyclical Investment rounds* may address Ofgem's concerns about the efficiency of addressing and comparing packets of projects, however we believe the constraints this approach creates on the supply chain and the developer outweigh the benefits of a packet approach.

- b) **To review our eligibility criteria for any potential future regime, and to explore the potential to raise the maturity threshold for applicants.**

**Eligibility criteria and CBA methodology**

Ofgem notes that *developers could be asked to provide more substantial evidence that their project is being actively considered in the connecting country for regulatory approval, and that a clear and well-defined route to market exists*. While it is important to ensure a high probability that projects obtaining IPA get built, it is important to note that project developers are faced with a multitude of project risks at the early stages of development. In many cases the regulatory environment in the connecting country is not sufficiently developed to facilitate the connection of non-TSO interconnectors. The IPA label has been a significant enabler in obtaining change with NRAs, without which many projects may have stagnated.

Ofgem will need to strike a delicate balance between setting an appropriate level of evidence required from IPA candidates against the risk of creating unassailable barriers for private developers to enter into the Cap & Floor selection process. An increase in evidence required by Ofgem may also have the impact of disproportionately favouring national TSO projects (with their larger resources and

privileged relationships with connecting TSOs) over private developers. Ofgem should avoid requiring greater evidence than it is prepared to offer itself to avoid a chicken and egg situation. We would go further and suggest Ofgem will need to demonstrate strong commitment to early-stage projects in the face of cautious NRAs in a post-Brexit environment. Ofgem's proposal for a more proactive engagement with the connecting NRAs is welcomed.

**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?**

**Corporation tax and capital allowance rates**

Under the existing C&F regime calculated tax allowances are annuitised and added to the cap and floor levels. Allowances for tax are determined at the FID stage and the final allowance is included in the RAV at the FPA stage. As there are currently no re-openers for changes to the RAV at the PCR stage, the developer, lenders and consumers run the risk that material changes in tax rates between FID and PCR will not be reflected in cap and floor levels. In the event of changes to corporation tax rates we consider that the tax building blocks for the cap and the floor be re-opened and recalculated to incorporate this impact.

In the RIIO-EDI price control for electricity distribution networks, Ofgem provided for tax as a pass through, stating "changes to or interpretation of tax legislation or rates of corporation tax or capital allowances are outside the licensee's control". In Ofgem's decision on the Hinkley-Seabank project there is an allowance for tax liabilities which includes "a project-specific tax pass through mechanism for the tax liability incurred by NGET through the construction and operation of HSB".

The RIIO-EDI and HSB examples demonstrate that Ofgem has agreed to alternative tax pass through mechanisms to share tax risk with customers. Customers would be exposed to both upside and downside with this modification, and as such could stand to benefit if corporation tax rates become lower than originally assumed.

We recommend that a change in tax legislation would trigger a reopener on the calculation for cap and floor levels for projects. The recalibration of C&F levels would form part of the regulatory audit for each interconnector on an annual or five year basis depending on the regime adopted by the project.

**Challenges faced by project finance developers**

**OPEX uncertainty at FPA**

In discussions with potential lenders to interconnector projects, we noted that a concern that additional costs of some events (*non-force majeure*) are outside of the control of the interconnector and should be classified as uncontrollable costs and passed through into the cap and floor arguing that a project finance structure should be capable of sustaining cost shocks. This risk is heightened given the 25 year period without reopeners. Having said that, lenders do not consider frequent cost reopeners are desirable as they reduce cost certainty and could lead to a reduction in the floor.

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

**Engagement with other NRAs**

Although not directly linked to the mechanism of C&F, the impact of Brexit has increased the risk of developing further capacity with GB's neighbours. The PCI structure was helpful in having a set of shared common guidelines to promote projects. Access to CEF grants was a material component to derisking projects in the early stages of development and to which consumers benefited through the corresponding reduction in project costs. The European Commission's current rhetoric is to remove GB projects from inclusion in PCI lists and potentially replace it with Projects of Mutual Interest (PMI).

This period of uncertainty comes at a time when GB and the Europe Union are looking to accelerate the energy transition where interconnectors are expected to play an important role.

We encourage Ofgem to consider additional mechanisms and structures to work with its European counterparts to avoid a long period of hiatus in interconnector development both for projects currently in development and future projects. Ofgem is well placed to take a leading role in the development of PMIs and work with BEIS to find a replacement for CEF grant funding.

We would be pleased to discuss any of these comments with Ofgem

Sincerely

Simon Ludlam