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Dear Andrew,

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

National Grid Ventures (NGV) welcomes the opportunity to respond to this Working Paper. NGV is a 50% shareholder in Nemo Link Limited, the first interconnector to operate under the cap and floor arrangements; as well as 50% owner in IFA2, which has been operational since early 2021 and also benefits from the cap and floor arrangements. NGV is also 50% owner of two further cap and floor interconnectors; NSL which is due to go live later this year, and Viking Link which is due to go live at the end of 2023.

The development of the regulatory arrangements for the four interconnectors mentioned above leaves NGV uniquely placed to comment on the efficacy of the cap and floor regime. NGV has worked closely with Ofgem over the last decade to develop and implement these arrangements and are pleased to see interconnectors moving through the development process into construction and operations.

NGV considers that the cap and floor regime has been broadly successful in incentivising the development of GB electricity interconnection capacity that delivers significant benefits for consumers (as identified elsewhere in the Interconnector Policy Review). NGV generally agrees with Ofgem's conclusion that a cap and floor regime is an appropriate mechanism to incentivise future GB interconnection, but would require further development for multi-purpose interconnectors.

NGV does have comments on the detail of the cap and floor arrangements, and in the following pages we respond to each of the questions asked by Ofgem in the Working Paper.

Section 2

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

Yes. Our only comment is that stakeholders would benefit from Ofgem publishing the 14 stakeholder responses to the call for evidence for workstream 1.

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

NGV thinks that the strengths, weaknesses, opportunities and threats identified by Ofgem are appropriate. We would suggest that Ofgem also considers the following:

- **Opportunity**: the cap and floor regime is potentially flexible enough to accommodate the next generation of interconnectors i.e. multi-purpose interconnectors (but would require adjustments). We look forward to engaging with the workstream 4 of the Interconnector Policy Review in this regard.
- **Weakness**: deviations from the cap and floor regime principles of a risk reward balance and level playing field have created a two-tier regime. Ofgem's impact assessment of the project finance regime variations showed a nearly £0.8bn (in NPV terms) reduction of consumer benefit across all five non-NGV interconnectors, implying a significant advantage for non-NGV interconnectors.
- **Weakness**: the way that the cap and floor is implemented, via special licence conditions, makes it difficult for stakeholders to identify changes from the core regime and may result in unjustified differences across projects. We recommend that the common elements of the regime (e.g. 60 days floor test, 80% minimum availability at the floor) are moved to standard licence conditions rather than having them in a multitude of special licence conditions.
- **Weakness**: the regime requires a high level of foresight on the costs of operating the interconnector, as it only contains a year 10 operating costs re-assessment. We recommend the inclusion of a mechanism for developers to raise incurred costs that could not have been foreseen (e.g. changes in insurance costs, interconnector customers' debt, introduction of network charges).

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?

Yes. NGV agrees with Ofgem's conclusions that the cap and floor regime has met its objectives. We also agree that Ofgem has considered the right information in its analysis.

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?

Yes, with a caveat. NGV notes that Ofgem has included sustainability benefits under the principle 'In the interests of existing and future consumers' and question whether a more targeted principle relating to sustainability may be more appropriate given the focus on achieving net zero.

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?

Generally, NGV recommends that Ofgem takes a much more 'case-by-case' approach to interconnector development. We consider that the likely small number of interconnector projects would not make this approach overburdensome, and considers that interconnector projects are all sufficiently unique to warrant a case-by-case assessment. We consider that taking this approach would result in better outcomes that better reflect the implementation challenges of each project. Further detail is included in the responses below.

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?

We noted in our response to the workstream 1 call for evidence that:

'Interconnector development is extremely complex in terms of the construction and deployment of technology, the long-term nature of any investment, requirements at the other end of the link, and the partner relationships that need to be developed to deliver successful projects. The cap and floor regime has so far successfully allowed this complexity to be appropriately managed and we are now seeing developments turn into reality'

This interconnector development (prior to final investment decision and any construction activities) can take many years, and much of this takes place without the developer having any regulatory certainty for the project. We support the proposals being developed via the OTNR for more coordination and a holistic network design, but note that as this applies to interconnectors (or MPIs) it should recognise the complex nature of these developments. We consider that the developer-led interconnector model remains most appropriate as it allows the necessary development work to take place with any partner company. The cap and floor application process should be designed to allow the most effective interconnector projects to come forward when sufficient development work has been done and the project is sufficiently mature and most likely to proceed.

NGV supports Option 1 'Case-by-case applications' for future interconnectors. We consider this to be appropriate for the relatively small number of projects that could reasonably be expected to apply. We also consider that Ofgem could develop appropriate criteria so that developers can demonstrate that projects are mature enough (see response to next question) and could also be asked to demonstrate alignment with any holistic network design that is delivered via the OTNR. Allowing applications on a case-by-case basis would also avoid any future problems associated with common milestone dates for cap and floor windows. This would allow Ofgem to determine project specific targets for dates such as 'Regime Start Date' and identify much more realistic project specific milestones.

Any pre-determined application window process runs the risk of either delaying projects that are ready to progress or bringing forward projects that are not sufficiently developed merely to meet the dates of the window.

NGV notes Ofgem's comment regarding the potential for a more proactive role for NGESO. If NGESO were to take a more proactive role, then this role would need to be very carefully developed to ensure that it complemented the efforts of interconnector developers to get their projects off the ground. We recognise that interconnector (and MPI) development needs to be aligned with any holistic network design delivered via the OTNR, and NGESO could undertake a role to make sure that this alignment is achieved. If NGESO is to take on such a role then Ofgem must ensure that NGESO is appropriately funded, and hence appropriately resourced with the right capability for it.

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

NGV agrees that it is important that an appropriate threshold is in place for applications. If the threshold is too high then it may deter beneficial projects going forward, and if it is too low there is the risk that projects gain regulatory approval but are subsequently not built. As previously noted, interconnector development is extremely complex with many challenges needing to be overcome before construction commences. Interconnector projects are also very unique, driven by issues such as the connecting country requirements, length of cable, and the requirements of the partners involved. With this in mind, it is difficult to set criteria that apply to all projects, and we recommend that Ofgem considers whether any criteria can be complemented with a project specific assessment (possibly based on a scoring system) where Ofgem considers the prospect of the project actually proceeding. This scorecard could be reviewed at regular intervals to assess progress, and action could be taken if sufficient progress was not being made.

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?

NGV notes that all the cap and floor window 1 and window 2 projects have faced difficulties (or appear to do so) to meet the timescales originally defined for these application windows. In respect of NGV projects, delays have been caused by issues outside of our control such as supply chain issues, consenting timescales etc. We recommend, alongside our proposal relating to the application process set out above, that Ofgem sets realistic, specific timescales for each project.

NGV also notes that changes have recently been made to the Force Majeure provisions and assume that these can be used by developers as necessary to demonstrate that issues outside of their control have delayed their project. It is widely established that developers have a clear financial incentive to deliver their project as quickly as possible as no revenue flows prior to the interconnector being operational. Ofgem should place more weight on this natural incentive and not penalise developers for delays when they are outside of the developer's control i.e. there should be more flexibility with regards to the Regime Start Date.

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?

NGV expects that any changes that are made to the financial parameters of the cap and floor regime are forward looking, with no impact on projects that have already taken investment decisions. We consider that any attempt to standardise methodologies across regimes needs to take into consideration the level of risk incurred by interconnector developers, which might be different than in other regimes. A suitable risk-reward balance needs to be maintained for interconnectors (and MPIs) to continue to be developed.

With regards to corporation tax, NGV welcomes Ofgem's review of this aspect of the regime and agrees in principle to the proposal to introduce a mechanism to reflect changes in the tax rate. NGV would welcome the opportunity to work with Ofgem on how the existing model could be adjusted.

In addition, NGV is aware that the Office of National Statistics is moving towards a more extensive use of the Consumer Price Index and a possible discontinuation of the Retail Price Index, which is currently used in the cap and floor regime. NGV therefore looks forward to engaging with Ofgem on how to future-proof the cap and floor licence conditions, with the key principle of achieving net present value neutrality for any changes to the inflation index.

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

The cap and floor regime was carefully designed by Ofgem over a number of years to balance the risks and rewards of interconnectors between developers and end consumers. A set of principles was developed to underpin the regime^{1,2}. NGV is supportive of those principles and strongly encourages Ofgem to fully follow them for any future regime development. In relation to any potential future regime change, NGV considers that the most relevant principles are:

- **Risk-Reward Balance**: Developers should be able to earn returns that are commensurate with the levels of risk they are exposed to under the regulatory framework.
- **Level Playing Field**: Regulatory treatment should allow third party developers and should be impartial and unbiased between TSOs and non-TSO developers, existing and future developers.

As discussed in response to question 2, non-adherence to the risk reward and level playing field principles has resulted in variations with a nearly £0.8bn (in NPV terms) reduction of consumer benefit, implying a significant advantage for non-NGV interconnectors.

A practical test for the level playing field principle going forward is to offer any regime variations to all developers, regardless of whether they have requested them or not. This would ensure that when changes are made to the regime no developer is left in a disadvantageous position. An example where this would apply is the debt rating used for the floor return, which was A/BBB for NGV interconnectors but has been changed to BBB for project finance interconnectors.

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

NGV has no further regime improvements to suggest at this time.

Section 5

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

NGV generally agrees with Ofgem's conclusions, subject to the comments made in previous responses.

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

NGV generally agrees with Ofgem's proposals, subject to the comments made in previous responses.

Other

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

NGV has no further feedback at this time.

¹ Cap and floor regime for regulation of project NEMO and future subsea interconnectors, page 14
<https://www.ofgem.gov.uk/publications-and-updates/cap-and-floor-regime-regulation-project-nemo-and-future-subsea-interconnectors>

² Preliminary conclusions on the regulatory regime for project NEMO and future subsea electricity interconnector investment:
https://www.ofgem.gov.uk/sites/default/files/docs/2011/12/preliminary-conclusions-letter_0.pdf

NGV is happy to discuss any aspect of this response in more detail with Ofgem. Please do not hesitate to contact me if you wish to do so.

Yours sincerely,

John Greasley

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