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Dear Andrew

Transmission Investment Response to the Consultation on the Interconnector Policy Review: Working Paper 1 – Review of the Cap and Floor Regime

Transmission Investment, as one of the UK's leading independent transmission companies manages one of the largest offshore electricity transmission portfolios. Our managed portfolio of Offshore Transmission Owner (OFTO) assets includes the connections to seven offshore wind farms, and we will take over management of a further three offshore wind connections in 2021 – in total a portfolio of approximately 3.2GW and over £2bn in capital employed. We are one of the largest managers of offshore wind transmission in GB, which is the largest offshore wind market in the world.

Transmission Investment is also a strong advocate of introducing competition into the delivery of onshore transmission and we continue to support the development of the required arrangements *inter alia* through industry groups, responding to consultations such as these and providing evidence to parliament.

Transmission Investment is leading, in partnership with the French national grid company RTE, the development of a proposed 1400MW HVDC interconnector between France and Britain via Alderney ("the FAB interconnector project"). This project was granted cap & floor regulatory treatment in 2015 and whilst it continues to experience Brexit related delays, it will commence construction as soon as the regulatory process allows. Transmission Investment is also in the early stages of developing a 700MW HVDC interconnector between Scotland and Northern Ireland ("the LirIC interconnector").

Ofgem's Approach to Workstream 1

We support Ofgem's approach taken to Workstream 1. We think that prior to considering how Ofgem may support future Interconnector projects that a full review should be performed on the regime. Broadly, this appears to have been carried out by Ofgem and critical elements have been identified and analysed as part of this review. However, there are several areas which we think could be improved and added for consideration which we point out throughout this response letter.

We have a few comments on the outcomes of the SWOT analysis used by Ofgem to perform a critical review on the regime. The working paper states that there were conflicting views

from the stakeholder engagement and if this was the case, these were pointed out. It is not clear from the provided information where there may be conflicting views and whether there were trends from the types of stakeholders on these conflicting views. We would support Ofgem adding further commentary on how these conflicting views were considered in any decision.

Our comments on specific points in the SWOT analysis:

Strengths

It provides the level of revenue certainty required to develop large-scale interconnector projects, striking a fair balance between risk and rewards for both developers and consumers: To date no interconnector project has completed a review period and so the C&F regime has not been called upon to provide revenue certainty or reward to consumers. Furthermore, there is little clarity on the process and timing of how payments between the Interconnector and the ESO (via TNUoS) will be made. The regime remains untested and has only successfully supported interconnectors developed by National Grid through to the operational phase. It has yet to be proven whether the regime provides sufficient cashflow certainty for an independent project to successfully reach the operational phase without the significant financial support of a large corporate entity¹. Whilst we agree with this statement of strength in theory it must be balanced with a weakness in that the regime is still in the relatively early stages and further experience of the regime in supporting an operational interconnector may drive further change. The current and any future regime should be able to accommodate these potential changes.

The flexibility to request regime variations is a positive intervention to enable a range of financing solutions: We do not regard the requirement for variants to be a strength. A fundamental objective of the Cap and Floor regime was to facilitate alternative forms of financing. The requirement to have variants of the regime means that the default regime is only capable of supporting corporate financing. This creates significant complication and inconsistencies presenting a potential barrier to all but the most informed investors. The inflexibility of the default regime should be seen as a weakness but also an opportunity to consider how all forms of financing could be supported in a single version of the regime. In doing so, this will allow Ofgem to simplify the regime and associated legal documentation. These concerns were raised by Transmission Investment in a response to the consultation on “Proposal to roll out a cap and floor regime to near term projects” dated 18th July 2014. We stated “...the required flexibility on those aspects of the proposed regime which are not suitable for non-TSO developers is evaluated and if necessary consulted upon. The final regime (available to both TSO and non-TSO developers) should then be available in time for the Final Assessment process of a project”.² This position did not seek a separate version of the regime but for the final regime to be available all types of developer.

¹ It was recognised in an open letter by Ofgem that “*certain aspects of the default regime may be less suitable for some types of financing solutions*”. Letter available at:

https://www.ofgem.gov.uk/sites/default/files/docs/cap_and_floor_regime_variations_open_letter.pdf

² Full response available from:

https://www.ofgem.gov.uk/sites/default/files/docs/2014/08/transmission_investment_response_cap_and_floor_near_term_projects_consultation.pdf

The application process, including the window approach, and subsequent assessment framework is clear and transparent: We recognise that this has been identified as both a strength and weakness. However, based on the stakeholder feedback set out in paragraphs 4.5 to 4.9 and 4.20 to 4.23 we do not see how Ofgem has identified this as a strength. Significant concerns have been identified in these areas including the transparency of the CBA process and lack of justification for a windowed approach. Whilst Ofgem may see wider support for the current approach it does not seem to reflect the views of stakeholders and therefore could be considered a misrepresentation of feedback by including it in the SWOT analysis as a strength. We provide further views on these two aspects of the regime later in this response.

Threats

Cumulative risk to consumers if many projects need floor payments and uncertainty on the ongoing participation of interconnectors in the GB Capacity Market: Both threats are related to interconnector revenue uncertainty. Whilst these certainly are a risk to an interconnector owner and therefore a project's business case, we do not consider them a risk to the Cap and Floor Regime. Revenue is only one input to the socio-economic Cost Benefit Analysis (CBA) which justifies the provision of the regime to a project. The threat here is either on the accuracy of the wider forecasted economic justification of the project or that the forecasted revenues are insufficient to bring forward economically justified projects. There is no risk to consumers if floor payments are required to ensure an economically advantageous project is viable and realised. Given Ofgem recognise that the benefits of interconnection may not be directly attributable to a project (for instance in providing system flexibility to support intermittent generation), these threats should be reworded to recognise the risk to consumers is if the regime is insufficient to bring forward economically advantageous projects. If these threats are the views of stakeholders, we would expect some analysis elsewhere in the working paper which discusses this point and the relationship between the economic justification for a project and its investibility.

Impact of the Cap and Floor Regime

The primary objective of the Cap and Floor regime has been cited by Ofgem in the working paper as *"We are aiming to bring forward timely, economic and efficient investment in interconnection where that is in the interests of existing and future consumers"*. We broadly agree that the regime has been successful in bringing forward interconnection that is in the interest of consumers. Where the regime may have fallen short of this objective is in the objective to bring this investment forward in a timely manner. However, we recognise this is predominantly due to issues in the connecting country (predominantly due to the UK's withdrawal from the EU), which is a focus area to be addressed as part of this review.

We also agree that the principles of the Cap and Floor regime remain fit for purpose, and we consider the regime suitable to incentivise further GB point to point interconnection at least in the nearer term. Where the regime may fall short in this objective is in the longer-term, where the economic need for further interconnection shifts from converging market prices towards the wider benefits of security of supply and increased flexibility to support intermittent decarbonised generation. Here potential revenues may be lower and not

proportionate to the economic need for a project. This will diminish the investibility of economically advantageous projects and therefore the developer-led approach may not be appropriate unless the regime bolsters the revenue incentive. This issue will be exacerbated due to the cannibalisation effect on revenues of further interconnection. As Ofgem assess the economic need for further interconnection they should also consider the potential revenues and ensure the incentive on developers to bring forward needed projects persists. The future regime should include flexibility to allow this assessment and potential adjustment to the regimes parameters to ensure incentives remain.

Potential Regime Improvements and Alternatives

We support Ofgem's intention to review the application window process for the reasons set out in the working paper. However, we would not want this to delay the opportunity for projects which are currently in development, but without regulatory approval, to apply for regulatory treatment. There is a clear need for further interconnection with GB as identified by NGENO³ and ENTSO-E⁴. To bring these projects forward in a timely manner Ofgem should ensure there is opportunity to apply for regulatory terms in GB as soon as is practicable.

We support Ofgem's view that a more coordinated system-wide approach to applications windows should be implemented. Furthermore, we support the intention for NGENO to take more of an active role in this process. NGENO currently consult on and publish the Network Options Assessment for Interconnectors (NOAIC). This is an independent, transparent and consistent process which considers system inputs and could be used as the primary input to Ofgem's needs assessment. A key risk in the early-stage development of an interconnector is in the approach to, and consistency of, a need assessment. Every economic forecast will, to some degree, be ultimately inaccurate. This can be due to unexpected changes in political targets, the wider economy and consumer behaviour. However, ensuring consistency in the approach to the economic assessment and clarity on which resulting economic indicators will be used to establish a need gives developers confidence in how the project will ultimately be assessed in a regulatory application. This would support developers in the very early stages of a project's development by ensuring consistency in the assessment of benefits throughout the development process. However, relying on an assessment by NGENO may require the NOAIC Methodology to be enhanced to ensure it meets the needs of Ofgem's assessment and mitigates the risk of requiring future changes.

We would like to provide the following comments on the options being considered for application windows:

Option 1: Case-by-case applications: This is our preferred option for the reasons set out in the working document. It would allow for better planning of a project as the regulatory

³ NGENO identified need for significant increases in interconnection across all of their FES scenarios in the Network Options Assessment (NOA):

<https://www.nationalgrideso.com/document/185881/download>

⁴ ENTSO-E identifies clear economic benefit to the EU and UK for a number of submitted projects to their Ten Year network Development Plan: [https://tyndp2020-project-](https://tyndp2020-project-platform.azurewebsites.net/projectsheets)

[platform.azurewebsites.net/projectsheets](https://tyndp2020-project-platform.azurewebsites.net/projectsheets)

submissions would be driven by the maturity of the project rather than the application window itself. Furthermore, it would mitigate bottlenecks in the interconnector supply chain and ensure the project can run a competitive process, timed to optimise against supplier availability rather than being driven by time constraints in the regulatory framework.

We do not recognise Ofgem's concerns around a lack of ability to compare projects within application windows. Costs are assessed for efficiency against benchmarked levels and the management of risks and capability of the developer to successfully realise the project can be completed without comparison with projects within a window. With Ofgem's proposal to take more of a system wide approach to the project CBA assessment the project will be required to demonstrate its design and connection location are cost effective against NGENO's input.

In previous application windows, Ofgem have considered the benefit of a project which goes ahead in isolation, and then the benefit if it goes ahead in parallel with other projects within the same application window. This ability would be lost if the application window approach were removed. However, we do not recognise the benefit to assessing the value of a project if other projects in the same application window proceed. The key question here is whether the applicant project is supporting the overall benefit of further interconnection to GB, and not just between the projects within the same application window. All IC project benefits are interdependent – a project on another border can increase or decrease the benefits of the applicant project. This is partly assessed in the current NGENO NOAIC where 'optimal paths' are identified including the optimal timing and location of future interconnectors considering the timing and location of all current and future beneficial projects. This approach could be used by Ofgem to expand the analysis from only projects within the same application window to identifying a project's interdependent benefits with current, applicant and NGENO recommended future interconnectors.

We think the concerns raised by Ofgem on this approach can be mitigated through a clear process and enhanced CBA. Given the significant benefits of this approach it is our preferred future option.

Option 2: Pre-determined window with pre-determined capacity level: We do not see this approach as practical. Optimal levels of capacity will exist on multiple borders rather than a general target level across GB. Practically this will result in Ofgem choosing which borders a project should be realised on and therefore align with proposal Option 3. Furthermore, the cost of an interconnector is not linear and there exist cost optimal levels of capacity for a project resulting in Ofgem needing to identify the potential number of projects to approve and the potential capacity of each, i.e. if 2800MW was proposed by Ofgem, is it optimal to approve two 1400MW projects or four 700MW projects. However, a decision on this will be driven by the size of projects being brought forward and may result in a 'capacity grab' (i.e. only 2800MW projects are proposed by developers). Whilst we support the principle of driving competition between developers, limiting the level of capacity in a window below that which is economically optimal may promote perverse incentives to kill off competing projects rather than driving efficiencies within projects.

Option 3: Pre-determined window with a pre-determined geographical scope: We do not support this approach for similar reasons to those set out in option 2. Additionally however, this options raises concerns over the requirement to need a Connection Agreement before submitting a regulatory application. If the location of eligible projects is constrained this will drive competition in obtaining optimal points to connect rather than driving efficiencies within

the projects themselves. As NGENSO and the relevant TO would need to provide a connection agreement to any applicant IC this may drive up the cost to connect for all potential IC projects. This approach would therefore require an adjustment to the way TO's manage IC connection applications to allow the relevant TO to consider that not all projects will go ahead.

Option 4: Cyclical investment rounds: We do not have any reservations to this approach as the principles of benefits we set out regarding Option 1 could be included. If this option were to be taken forward, we would support an annual approach and defined review and decision timelines to give clarity to developers. However, the subsequent timing requirements within the regime must have sufficient flexibility to allow consideration for the connecting market regulatory approval process and any specificities of the applicant project. If deadlines are to be included in any future regime these should be cognisant of this and set in isolation to the timing and regularity of the investment window and strict deadlines should be avoided.

We support Ofgem's view that the CBA methodology should be reviewed and will provide a detailed view of this process in our response to Workstream 2 of the IC Policy Review.

In terms of the eligibility criteria to make an application, we would urge Ofgem to also take account of which option for the application window is to be implemented. If developers can make a regulatory application at any time this would support a higher level of maturity being required for a project to be eligible. Conversely, if a defined window approach was taken forward such as Option 2 or 3, the level of maturity required to be eligible must be lower. For a developer to align an enhanced maturity level with a more defined requirement for the application window could be seen as too great a risk to begin early-stage development. This would disincentivise developers to bring forward projects and conflict with the objectives of the regime. The required maturity level and associated timeframe constraints within an approval must be balanced with the terms of the window to create a fair overall eligibility criterion.

The working document sets out Ofgem's intention to enhance the due diligence on a project with respect to the engagement with the connecting regulatory authority. We support this intention as an area we felt has been avoided by the regime to now. To implement this in an efficient way Ofgem should ensure that any requirements are developed transparently, and clarity provided on where the due diligence requirements may sit within the regime (i.e. as part of any maturity threshold or a requirement to be provided at the FPA stage). Any engagement with the connecting regulatory authority with regards a specific project should be done on completion of the CBA process ensuring Ofgem are able to take a substantiated position towards the connecting regulator.

We would also support Ofgem including in any future regime consideration on how further interaction with the connecting market regulatory authority could be used to identify and mitigate any potential conflict between the two regulatory approval processes. If the project is identified as in the interests of GB, the due diligence should identify potential points of conflict and seek to mitigate any compatibility risk to the extent possible within the regimes. This would include aligning and setting out realistic timeframes.

Furthermore, with regards engagement with the connecting country regulatory authority, consideration should be made for how the approval of a project in GB may affect the approval process of any other projects being considered by the connecting NRA. Connecting countries do not use an open developer-led model and therefore projects are chosen and supported in

coordination with the local System Operator based on their economic benefits. If the associated benefits of projects are interdependent a decision on which to approve becomes very difficult if it must be justified that it has been achieved in a non-discriminatory manner. If Ofgem identifies that the benefits of a project are largely interdependent (as was the case on the GB-Fr border for the Window 2 projects) it should be stated that Ofgem will only provide regulatory support/approval if the more mature project falls away. This will ensure the Cap and Floor regime is compatible and supports the regulatory process in the connecting market.

This issue has been raised previously by Transmission Investment in our consultation response to the IPA of Gridlink, NeuConnect and NorthConnect projects. We stated: *“...the (“minded-to”) decision to grant IPA status is also taken in isolation of the views of the non-GB regulator (or other organisation required to give approval for the project to proceed). Whilst we would not argue that Ofgem should be seeking to promote projects at this stage with their opposite numbers in non-GB countries, we do think it would be useful to understand their position, and to take account of it in the IPA decision. This could be as much on the timing of the decision as to whether to grant a positive decision. A more joined up approach would be beneficial for the project developer and for the GB consumer.”*⁵

Our general comments on improvements for the regime can be summarised as follows:

- The incentive mechanism within the regime to ensure the timely delivery of a project is predominantly related to a reduction in the regime duration by holding the Regime Start Date (RSD) at that stated at the IPA stage. We do not consider that this adds incentives to a project developer beyond the incentives that inherently exist. It is in the interest of a developer to move a project to the operational phase as quickly as is possible ensuring all risks are managed appropriately. Delays to the operational phase are delays to the return on investment. We do not recognise a situation where it is in the developers’ interest to unnecessarily delay a project. The predominant incentive therefore only serves as a disincentive to invest and therefore develop a project which is contrary to the objectives of the regime. The view of what is timely from a regulator perspective should be grounded in the economic interest of GB consumers. If it is not economically justified to reduce the regime duration the regime should not do so merely to penalise the developer for a delay. We recognise and welcome that Ofgem have approved a process whereby a developer can claim relief from the RSD in the case of a force majeure (FM) event. However, the decision on whether an event is a FM is taken towards the end of the development phase and the process set out by Ofgem is entirely at the discretion of Ofgem.

We recognise that unforced delays due to incompetence or inefficiency of a developer may exist. These should be mitigated through the already established process of ensuring incurred costs are efficient. If it is justifiably deemed that costs are inefficient by Ofgem, the costs are disallowed under the regime to the detriment of the developer. This should serve as sufficient incentive on developers without requiring a reduction in the Regime Duration, possibly also to the detriment of consumers (i.e., if

⁵ Our response was confidential and has therefore not been published. Associated decision from Ofgem available at: <https://www.ofgem.gov.uk/publications/decision-initial-project-assessment-gridlink-neuconnect-and-northconnect-interconnectors>

revenues are expected to be above the Cap in the period following the end of a reduced regime duration consumers will not see this benefit).

- The legal grounding of the regime has never been fully clarified and there is concern that there may be conflict with the use of revenues requirements on Interconnector owners. Any future regime or update to the Cap and Floor should be accompanied by clarity of the legal terms under which it operates. This will support investors in identifying the legal ground of the regime and reduce the risk of future adjustments.
- The asset life expectancy of an interconnector is greater than 40 years. However, the regime does not consider any benefit beyond 25 years and is silent to how this period may be considered. This limits the level of perceived residual value forcing investors to only include the regime period in terms of cashflow certainty. This inflates the cost of financing, raising the level of the floor and therefore risk to consumers. In any future regime update we urge Ofgem to provide clarity on how a project may be considered beyond the regime period. This will support any residual value being considered in financial modelling and potentially reduce the financing costs of the project.
- We have raised several times our concerns regarding the Trial Operations requirement within the regime. The current requirement exceeds that available from suppliers resulting in the risk of the owners being forced to sign off the asset before the floor start date. The regime is designed with the intention to ensure the asset can deliver against its design avoiding exposing consumers to asset issues. We agree with this design intention but the requirement within the regime being beyond what is available from suppliers makes the requirement overly onerous and creates an investment risk where none should exist. Depending on the financial structure for the project, it may be essential for the regulatory requirements to be imposed upon the procurement specification. This may reduce competition and inflate prices unnecessarily. Furthermore, if imposed upon the procurement for the whole project not just the GB portion (as one would expect) it may be seen as inefficient in the connecting market and cause conflict with regulatory approvals there. Normally, the parameters of the Trial Operation period are negotiated through a competitive tender with potential suppliers. If this tender is deemed competitive and the Trial Operation aligns (or exceeds) industry standards, then we do not see any justification for the regime not aligning to this.
The level of the floor is insufficient to justify the investment alone and so there is a sufficient cashflow risk incentive within the regime for interconnector owners to ensure their assets are capable before they are taken over. We urge Ofgem to reconsider their position on this as it is an unnecessary risk and therefore potential barrier to efficient forms of financing.
- The current regime is complex and difficult to understand if not directly involved in the regulatory development process. We recognise and welcome the publication of a Cap and Floor Handbook and would support its continual update as and when required. Additionally to the current draft, we would encourage Ofgem to include further information related to the timing and information requirements within the IPA, FPA and PCR review processes. A generic Financial Model should also accompany the Handbook ensuring it is continually updated with the latest market related indices

and available on the Ofgem website. The Ofgem Cap and Floor model is an integral part of any project investment decision financial model and ensuring clarity on its workings and parameters is essential for project promoters to be able to construct their own financial model around this. Furthermore, as part of the IC Policy Review, we would welcome Ofgem reviewing the overall regime with a view to simplify its requirements, legal terms and process.

- We have raised on a number of occasions our concerns that the information requirement for the FPA is overly burdensome and causes significant risk to the integrity of the procurement process. We would urge Ofgem, in any regime update, to ensure that only information which is absolutely needed for approvals is required as part of any submission. This will support a more efficient process, reduce the review timeframes and mitigate concerns associated with the requirement to provide procurement sensitive information.
- The penalising level of interest accrued on revenues above the cap disincentivises an interconnector owner to more generally achieve levels of revenue above the cap. For a given review period, if revenues from capacity sales results in levels above the cap there is no incentive and possibly a penalty to earning more. As revenues above the cap are indirectly returned to consumers this disincentive cannot be aligned to wider socio-economic interests and we would welcome Ofgem's review of this part of the regime's design.

Conclusions and Recommendations

We broadly agree with the conclusions drawn by Ofgem. Furthermore, we welcome the aspects identified that could be improved upon to better meet the objectives of the regime.

We also broadly agree with most of the principles of the initial proposals set out. However, we do not agree that the review should move towards a more targeted window-based approach on a capacity or locational basis. This could be significantly detrimental to the process as set out earlier in this letter. We would urge Ofgem to consider whether the benefits Ofgem see in targeted windows could be achieved through an enhanced CBA assessment which considers how an applicant project's benefits may sit within an 'optimal path'. This analysis is something NGENSO currently perform when recommending future projects in their NOAIC analysis. This approach could be used for Ofgem's analysis to identify interdependent benefits, not only on approved and applicant projects, but also on economically optimal future projects. This would also mitigate the requirement to artificially limit application windows that may create competition with perverse incentives on developers.

Finally, we would like to raise our concerns on Ofgem's lack of ambition on the timing for a future application window (or alternative). No timeline is set out within the working document and so it is not clear to developers when this may be available. Transparency on Ofgem's expected process and timeline for a project to apply for regulatory treatment should be set out in any decision. As mentioned previously in this letter, a clear need for further interconnection has been identified by several independent studies and the recent Ofgem/AFRY study being used to support work steam 2. The regime (as well as developers) should support these projects being brought forward in a timely manner.

If you would like to discuss any of the comments above, please feel free to contact me.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Richard Sidley', with a long horizontal stroke extending to the right.

Richard Sidley
Regulatory and Commercial Manager