NeuConnect

NeuConnect Britain Ltd
105 Piccadilly
London W1J 7NJ

Arnaud Grévoz
NeuConnect Chief Executive Officer
arnaud.grevoz@neuconnect.eu
www.neuconnect-interconnector.com

Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

23 May 2022

RE: Response to Ofgem's consultation on the Final Project Assessment of the NeuConnect interconnector to Germany

NeuConnect and its consortium of international investors welcome the opportunity to respond to the Ofgem public consultation on the Final Project Assessment for the NeuConnect Interconnector project.

On the pages that follow, we have set out NeuConnect's formal response to the specific questions raised by Ofgem in the consultation. However, in this covering note we also feel that it is important to highlight some wider points and the important context in which Ofgem's FPA decision will be made:

The delivery of NeuConnect is at a pivotal point

- As you know the NeuConnect project is at a late stage of development – all major planning permissions are in place; new laws have been approved in Germany; major contracts have been awarded; and we are just a few weeks away from Financial Close. Ofgem's FPA decision is, therefore, the last remaining 'piece in the jigsaw' to be completed before we can focus on starting major construction in 2023. It is vital that the final piece of GB regulatory approval is put into place to make NeuConnect a reality. Any delay would result in (i) substantial consequential delays to the secured construction schedules, (ii) significant increases in project and construction costs and (iii) significant reduction of GB consumer benefits. Such a delay scenario would ultimately be extremely difficult for the supply chain and the NeuConnect sponsors to accommodate. This could, therefore, result in the cancellation of the NeuConnect project altogether, thereby eliminating all economic, environmental, and other benefits of the project.

The need for more secure, sustainable energy infrastructure has never been greater

- Government ambitions for 18GW of interconnector capacity to support 'Net Zero' targets and greater energy security in the UK have taken on an added urgency in light of the huge turbulence we are seeing in the energy industry and the wider geo-political situation across Europe. Projects like NeuConnect are, therefore, more vital than ever – as our submission sets out, NeuConnect will make a crucial contribution to UK interconnector targets; it will deliver significant consumer benefits and carbon reductions; and it will greatly improve diversity and security of supply by connecting the UK with the German energy market for the first time.

NeuConnect Britain Ltd
105 Piccadilly
London W1J 7NJ

The successful delivery of NeuConnect will set an important wider precedent

- NeuConnect is ahead of all other window 2 projects in its readiness to begin construction, and is also one of the very first project-financed interconnectors being delivered. The successful delivery of NeuConnect will therefore set an important wider precedent – it will clearly demonstrate the success of the 'Cap and Floor' regime as Ofgem looks to attract future developers and investors in 'Window 3'; and it will demonstrate the viability of 'project-financed' schemes, helping to encourage further project-financed investment (whether in Window 3 or beyond) which will help to add further choice and competition in the market.

Given the important matters at stake as outlined above and in our full submission below, we look forward to continued engagement with Ofgem and to a timely decision on the Final Project Assessment in the coming weeks. If you require any further details from NeuConnect in the meantime, please do not hesitate to contact us.

Yours sincerely

Arnaud Grévoz
NeuConnect CEO

NeuConnect Britain Ltd – formal response to Ofgem's consultation on the Final Project Assessment of the NeuConnect interconnector to Germany

The response that follows from NeuConnect Britain Ltd ("NBL") is structured to reflect the order of the questions raised by Ofgem in the consultation.

NBL would like to draw Ofgem's attention to the fact that part of its submission contains commercially sensitive information. All parts of this response are not confidential other than the following sections:

- Appendix A "**Further considerations on land cost disallowance"**
- Appendix B.2 "**NeuConnect socio-economic welfare impact annexes**"

The two sections above should be kept confidential.

1. Introduction

General feedback
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comment?

NBL has no particular comment on the overall process, nor on its tone, content and conclusions.

2. Background

Ofgem does not ask specific questions within this particular chapter

3. Cost assessments

Question 1: Do you agree with our proposed cost allowances?

NBL would like to draw Ofgem's attention to three specific topics.

- Disallowance of Delay in Start-Up (DSU) insurance
- Disallowance of costs of land
- Disallowance of DEVEX costs

3.Q1.1. Response on DSU element of FPA

NBL believes the beneficiaries identified by Ofgem from the proceeds from any DSU insurance to be factually incorrect. NeuConnect believes the DSU insurance costs should be permitted as part of the cost allowances for the reasons identified below.

DSU insurance is part and parcel of a project finance transaction[1]. Lenders lend against a stream of expected cash flows. Any delay to the start of these projected cash flows arising from the occurrence of an insurable damage event will trigger the DSU insurance policy to respond. The DSU policy pays a fixed amount per day of delay to cover, at least, the debt service portion of the project costs and ongoing operational costs.

Without a DSU policy in place some lenders may not lend and the pool of lenders may become more restrictive. Those lenders that would be prepared to lend without a DSU will replace the effect of the DSU by seeking the necessary comfort through additional stand by facilities or a shorter tenor over which the debt will need to be repaid. This increases the total cost of debt and the Actual Cost Of Debt ("ACOD") Floor in each and every year; when compared to a case where DSU insurance is purchased.

Thus, a direct benefit to consumers from the presence of a DSU insurance policy exists, which is counter to the assumptions Ofgem cited in proposing to disallow the DSU costs.

Ofgem's view stems from its treatment of DSU costs in balance sheet funded projects where it is the project that benefits from any insurance proceeds rather than consumers. However, this assumption does not hold for project financed interconnectors given the linkage between debt tenor and debt costs which directly affect consumers' risk exposure.

Ofgem has consistently viewed consumers risk in the varied cap and floor regime for project financed interconnectors as being capped at the ACOD Floor level rather than at the Notional Floor level, despite the existence of an obligation on the Licensee to repay the difference between these two floors to consumers if used.

This is because in a scenario where revenues are never above the ACOD Floor and the project fails consumers will unlikely to benefit from those Licensees repayment obligations. Whilst the chance of this may be considered unlikely, it certainly is not impossible. Consequently, it is important to compare

[1] See "Principles of Project Finance", E R Yescombe, Academic Press, 2002 p129.

the risks consumers face with and without the DSU insurance costs in the ACOD Floor as this sets the limit on consumer risk.

NeuConnect used its financial model to calculate the Notional and ACOD Floors under the scenarios described above and the results are in the table below.

<table>
<tr><th>Scenario</th><th>Notional Floor</th><th>ACOD floor</th></tr>
<tr><td>1.DSU costs included</td><td>68.12</td><td>75.73</td></tr>
<tr><td>2.DSU costs excluded</td><td>67.84</td><td>-</td></tr>
<tr><td colspan="2">2(A) ACOD margins for all facilities for each + 5bps</td><td>+£0.44m per annum compared to an ACOD Floor without the DSU[2]</td></tr>
<tr><td colspan="2">3 Additional 6m of tail to ACOD</td><td>+£0.83m per annum compared to an ACOD Floor without the DSU</td></tr>
<tr><td colspan="3">Please note that the floor figures are based on the sculpting case in the model, ie no contingency is drawn in the above scenarios</td></tr>
</table>

The difference in the Notional Floor with the DSU costs included compared to where they are excluded is £0.28m per annum higher.

If DSU Costs are allowed in the cost base the ACOD Floor will include these and be set at £75.73m per annum which represents the maximum annual risk to consumers.

Whereas, if no DSU insurance is subscribed by NeuConnect, lenders' margins may increase as described above, or the debt is required to be repaid over a shorter duration which requires a longer tail.

For each 5 bps increase in margin across all facilities this increases consumer risk by £0.44m per annum. Whereas a 6 month increase in the tail length results in an annual ACOD Floor increase of £0.83m per annum and therefore both impacts increase consumers risk compared to allowing the DSU insurance costs.

Noting that consumers do benefit directly from the presence of DSU insurances in a project financed interconnector the lowest risk and cost for consumers is achieved by allowing the DSU insurance costs as eligible costs.

3.Q1.2. Response to Land Cost Disallowance

Please refer to Appendix A "Detailed considerations on costs" for further details on this topic.

Ofgem has disallowed a majority of NBL's costs for land acquisition within the UK, both within the DEVEX and the CAPEX categories.

[2] The absolute cost of the ACOD Floor without the DSU is not given as it is not a bankable alternative.

NBL understands that some land acquired from local landowners on the Isle of Grain may not appear by Ofgem to be "efficient" but this was due to the reticence of the landowners to divide their land into only the required parcels NBL needed. Therefore, acquisition of all of the land offered for sale was necessary to ensure land for the converter and cable existed in the location where National Grid proposed connection to its grid.

Furthermore, NBL disagrees with some aspects of the disallowance proposed for the reasons set out below.

1. the methodology applied by Ofgem in calculating the size of the disallowance should include land required for Biodiversity Offset (BO), as this is mandated by law for sustainable development and would correspond to Ofgem's statutory duty to take decisions to contribute to the achievement of sustainable development;
2. certain costs included within the disallowance actually relate to German land that were included within the GB total land costs in error; and
3. the unit rate used to derive the cost of the required land is wholly unrepresentative of the market value of that land, as evidenced by independent chartered surveyors.

Fuller explanations are included in Appendix A to justify the numbers suggested below.

As mentioned above and rounded to 1 decimal place, the correct cost for the operational land including land for biodiversity offset should be £4.7m. To this the following should be added in full as these costs are either not related to GB land or are not a function of land area:

- GB land advisory fees of £0.19m;
- German Converter land of £2.771m;
- German land option fees and German land advisory fees of £0.5m;
- This gives a total cost allowance of **£8.2m**.

Any disallowance should be related only to the non-operational land which is a proportion of the original purchase costs representing **£2.2m**.

NBL notes that the ongoing environmental permit liability associated with the non-operational land will be for the sponsors account and any proceeds from sale of the non-operational land, or revenues associated from its re-use, will also be for the sole benefit of the sponsors, if this approach is adopted by Ofgem.

NeuConnect believes the adjusted land value using the approach advocated and explained in Appendix A, along with the treatment of ongoing remediation and resale of non-operational land establishes a fair position for consumers and sponsors alike and recognises the development will be sustainable in line with best practice.

3.Q1.3. Response on Devex Costs

Ofgem stated that it is minded to disallow the following categories of estimated development expenditure from the UK cost base used to set the preliminary Notional Floor.

Ofgem identifies these disallowed costs as being related to:

- Originator Success Fees;
- Additional fees payable to the original developer;
- Sponsor development fees for existing shareholders as a development premium; and
- A proportion of those costs related to the acquisition of the converter station land.

NeuConnect has separately addressed its view of any disallowance in relation to the converter station land and hopes Ofgem is minded to agree with NeuConnect on its re-evaluation.

NeuConnect sets out its view below on why the other development costs should be allowed and the consequences for GB consumers of not allowing these.

Private Finance norms and Developer Premiums

Firms engaged in non-recourse finance project development will often carry out very risky early stage development on a number of projects simultaneously. Not all will reach financial close, indeed, it is not unusual for only 1 in 3 projects to reach financial close. It is, therefore, essential for Ofgem to recognise that early stage development works will be rewarded at an appropriate market rate as is customary in non-recourse finance projects.

Starting a project without any certainty that relevant permissions will be granted and where substantial costs need to be incurred before applications for permissions can be made requires sponsors to be comfortable that such early-stage works will be suitably recompensed if the project reaches financial close. It is normal to reward those taking these early risks in the form of a premium on the early development funds invested, which is paid out of funds drawn from the debt secured from lenders once financial close proceeds. If Ofgem disallows development risk premia this will send a signal to the market that will reduce rather than enhance the number of developers wishing to take on early-stage development risk (e.g. for next Cap and Floor Window 3).

As stated in our FPA submission, the sponsor development fees are risk premium fees to be paid to sponsors for taking on early project risk prior to securing the project financing and the originator success fees are in effect deferred consideration payable to Greenage Power at financial close in consideration of the transfer of contract and other rights from Greenage Power to NeuConnect Britain Limited, recognising Greenage Power's role as the originator of the project.

Recognising and allowing the remuneration of these sponsor and originator fees critically supports the attractiveness of these kind of projects for investors and will increase competition in the pool of capital wishing to invest in assets of this nature; which is a specific objective Ofgem set out to achieve. Disallowing them, in contrast, sends a signal to the market that such early effort and risk capital is not rewarded in the cap and floor framework and this will reduce developer appetite and competition in the interconnector market.

Proposed Disallowance Lowers the Cap and Increases Developer Risks

Disallowing NeuConnect Britain Ltd's contractual cost commitments to its main sponsors and early developers would lower the Notional Floor. It would also lower the cap. Therefore, NeuConnect Britain

Ltd would have no opportunity to share the costs of the risks incurred in relation to the early-stage development with consumers.

Where revenues are lower than expected, consumers would not face any exposure to the early development risk with the exclusion of these costs from the Notional Floor. Whereas sponsors' risk would be magnified by the exclusion of these costs from the Notional Floor because excluded costs would still result in contractual payments being made from the debt drawn and included in the ACOD Floor; widening the gap between the ACOD Floor and the Notional Floor.

As this gap increases, both the size and likelihood of any top-up reimbursement due from NeuConnect Britain Ltd to consumers increases and this reduces any distributions to sponsors from the project; potentially reducing project returns to levels below which sponsors may wish to proceed; or new projects wishing to begin early development activity[3].

The result of Ofgem's proposed decision is that marginal projects may no longer be considered viable shifting the supply curve against the interests of consumers as developers become more conservative in their development assumptions.

This is an issue for the UK, which has a strategy built on aspirations to increase its interconnection with its neighbours to 18GW by 2030. As each new project comes on stream it may capture a portion of the revenues of all other operational interconnectors. This increases the chances of revenues being lower in the future than they would have been without the additional interconnection. Therefore, the exclusion of the early-stage developer risk premiums from the Notional Floor (if the Notional Floor is ultimately relied upon) will erode project returns further. For the independent developer this is a significant concern and will reduce the flow of private capital into this sector if returns are close to or below the required threshold to either invest or take the early-stage development risk.

NeuConnect calculates that Ofgem's preliminary decision is more likely to create investment barriers and stifle development from independent developers at a time when more investment capital rather than less is needed to transform the energy prices, security and delivery of net zero in the UK in a direction which benefits consumers. This needs to be weighed against whether the inclusion of such costs in the Notional Floor for NeuConnect materially outweighs the potential benefits from more competition in the development of interconnectors.

Moreover, since any disallowance would also reduce the cap then should a situation arise where the project overperforms, the revenues above the cap would be captured by consumers. This means that even in the situation where the project is extremely successful, sponsors would be deprived from the opportunity to replace the lost early-stage rewards.

[3] This is a real concern given the impending opening of the new window 3 and developers assuming that early works will attract the normal development premium.

4. Other aspects of Ofgem's Final Project Assessment

Question 1: Do you agree with our proposal to set an availability target of 94.37% for NeuConnect based on the updated report by GHD consultants?

NBL has no comment on Ofgem's proposal

Question 2: Do you have any views on the technical assessment carried out on NeuConnect?

NBL has not identified any issue on the technical assessment carried out by Ofgem.

Question 3: Do you agree with our view that, on balance of the information we have, Option 1 of our needs case review is in the interests of today and future GB consumers?

4.Q3.1 Option 1

NBL agrees strongly with Ofgem's view that Option 1 of Ofgem's need case review is in the interests of current and future GB consumers. Furthermore, NBL sets out below reasons why Option 2 is not a viable option for the project.

4.Q3.2 On the non-viability of option 2

This question refers to Option 1 as being an FPA decision along the expected timeline (which NBL understand as being before the end of June), as opposed to Option 2 which would result in deferring the decision until Ofgem has come up with an updated methodology for assessing the need for NeuConnect.

NBL would like to underline that the consequences of option 2 may not be a delay of "one year" as portrayed by Ofgem in the consultation – in fact, the consequences would be considerably worse in terms of 1) the delivery timelines of the NeuConnect project; 2) the consumer benefits it offers; and 3) whether the project can still be delivered at all.

We have set out these potential consequences and risks in further detail below under a series of headings:

Procurement risks that would threaten deliverability:

- NBL has entered into contracts with the main contractors for the project, for both the cable and the converter stations. Within these contracts, each contractor has committed to a programme of works that is consistent with the capabilities of their respective supply chains. In the paradigm created by the COVID 19 pandemic and the Ukraine war, supplies of many goods including metals are significantly tighter than before these events occurred. The consequence is that these work programmes would be especially sensitive to such a major disruption. NBL has taken all reasonable steps to ensure that such disruption does not happen, for example by requiring the cable provider to book in advance the main quantities of metals it needs. However, contractors are still dependent on the available factory timeslots and other supplies.

- There is presently no commitment from the selected contractors to any other timetable or price than the ones agreed with NBL. Therefore, if option 2 were to be chosen by Ofgem there is no guarantee from the project sponsors (or the supply chain more generally) that the price would match that already agreed, or that the delay would be contained to one year. It, therefore, follows that without clarity on these two points there cannot be any guarantee offered by the sponsors to continue to take forward the project.

A negative impact on consumer benefits:

- For consumers, the impact of choosing to delay a decision to proceed with the project by Ofgem, could lead to an unquantifiable risk of delay and increase in cost level which could in turn lead to the supply curve not shifting in favour of consumers either in the short term or ever.

A risk of lenders withdrawing from the project

- On the financing side, NBL has managed to gather a large pool of lenders including multilateral agencies and leading commercial banks, who understand that Ofgem's decision is of paramount importance to the project. Strong support for the project from British and German authorities throughout the last years has been a strong argument to secure lenders' support. Should Ofgem's Final Project Assessment decision be delayed, it would send a very negative signal to the market and we would expect some lenders to lose interest in the project and withdraw funding capacity.

Taking on board all of the clear risks outlined above, NBL strongly agrees with Ofgem's preference for option 1, which we think is in line with its statutory obligations. It would not be reasonable to delay any decision, as implied by option 2, when that may result in unquantifiable or unknown consequences and when there is a possibility to base such decision on an established framework as outlined in option 1.

Such established framework is closely adhered to by the Cost and Benefit Analysis performed by FTi Consulting, an independent expert, and commissioned by NBL (see reply 4.Q3.3). The underlying assumptions of the expert study are adjusted to feed in firm knowledge of the current net zero policies of each connecting country and price adjustments seen since the industry FES scenarios published by National Grid ESO last summer.

As part of the independent CBA, necessary adjustments for recent market movements have been reflected in the input assumptions coupled with updated project costs and certain delivery programmes. This will provide a reliable and strong evidence of the size of GB consumer benefits made available by NeuConnect. The detail is present in Appendix B.1 and B.2 to this response.

For the reasons stated above, NBL considers option 1 as the only viable option to be used by Ofgem.

Any other approach will jeopardise the project's delivery.

4.Q3.3 On the benefits of NeuConnect for the British consumer and Great Britain as a whole

We provide as part of Appendix B.1 and B.2 the evaluation of the benefits brought by NeuConnect, as evaluated by FTi Consulting (FTI-CL), acting as an independent expert.

FTI-CL has analysed the impact of NeuConnect on GB's socio-economic welfare (SEW) using the following equation: (i) change in consumer surplus; plus(ii) change in producer surplus; plus(iii) change in IC (non-NeuConnect) rents; plus(iv) NeuConnect Congestion rents; less(v) NeuConnect's cost.

As a result, FTI-CL's detailed assessment identifies the following significant benefits:

- **NeuConnect will deliver £2.09 bn of consumer benefit for the British consumer until 2050**
- **NeuConnect will deliver a 13.3 Mt reduction of carbon emissions over the same period** (mainly due to a reduction in the curtailment of renewable energy and the displacement of thermal alternatives)

We, therefore, do not share Ofgem's view that "Benefits A" (which refers to quantitative benefits resulting from a reduction in price) may be low or negative. "Benefits B", including the optimisation of the use of renewable energy, are also very significant.

Additional benefits of NeuConnect, such as contribution to ancillary services and to the GB Capacity Market, evidencing the contribution to GB system security, have not been quantified in this assessment. Specifically, these factors could enhance the benefits of NeuConnect to GB consumers reducing the cost to maintain system stability and, in particular, increasing supplies of lower marginal cost capacity provision compared to a GB Capacity Market where NeuConnect was not participating. The result would be to lower the marginal price needed to achieve the capacity commitments required to secure supplies for the GB market. Given that these factors could not be quantified for this assessment, the estimated impact should accordingly be seen as a lower bound estimate in this regard.

To perform the assessment of NeuConnect, FTI-CL has developed a set of assumptions regarding demand, generation mix, commodity prices, and others that is referred to as the 'Policy Scenario'.

This scenario reflects a decarbonisation pathway consistent with the Net Zero ambitions / legal commitments of European (including UK) governments.

The Policy Scenario has been developed using a range of third-party projections, FTI-CL's expert judgement, as well as NeuConnect's input on project-specific issues, e.g. project costs and timeline.

Examples of third-party projections include, among others:

- European Network of Transmission System Operators for Electricity's ("ENTSO-E's") Ten-Year Network Development Plan ("TYNDP")
- National Grid Electricity System Operator's Future Energy Scenarios ("FES"); and
- Germany's National Energy and Climate Plan ("NECP").
- The Policy Scenario (version from 2020) has been used in the past in publicly available reports.

We note that Ofgem has identified that the NOA-IC report "*recommends interconnection to Germany, at a later date than 2028, in only one scenario (Leading the Way) of the four Future Energy Scenarios (FES), and that this may suggest that interconnection to Germany, in the remaining three FES, is likely to create lower total socio-economic welfare when compared to alternative locations*."

NBL would like to raise the following observations:

- The Future Energy Scenarios that are available in the NOA-IC report were established in the beginning of 2021 and no longer reflect the current situation of the market energy, especially regarding the long-term prospect for the supply of gas. We do not know what the results of that same study will be once the FES scenario have been updated;

- Comparing connection to Germany to other locations makes sense only if such other locations have expressed an interest in sharing a connection with Great Britain, and interconnector projects to these locations have reached a similar development stage as NeuConnect's, which is certainly not the case. The NOA-IC statement refers to connections to countries that either do not intend to allow any other independent interconnector in the near future, or where no project currently has a cap and floor agreement in principle or an exemption from the requirements of third-party access. NBL believes Ofgem should treat such statement with caution given that the claims made cannot be supported by any physical evidence that would allow such statements any credibility.

- The 2022 NOA-IC report by NG-ESO indicates that "*a total interconnection capacity in the range of 18.2 GW to 29.5 GW between GB and EU markets by 2041 will provide the maximum benefit for GB consumers*". Such a capacity is extremely ambitious and is certainly not achievable if well advanced and construction-ready projects such as NeuConnect are discarded.

5. Annual reporting and Post Construction Review

Question 1: Do you agree with our proposed approach to the post-construction review?

NBL would like to comment on one particular item (5.12) of the PCR process.

NBL notes Ofgem's statement that "*If NBL have reasonable grounds to believe that some of the remaining construction works might be exposed to certain risks after this point, we intend to provide them with an ex-ante allowance for managing these risks, which would be granted as part of the PCR and would not be reopened.*"

It is NBL's view that on complex projects such as NeuConnect, certain risks may materialize late during the course of the project and/or take time to be addressed with due care and in an efficient manner. Some construction-period risks may not be completely closed even when commissioning has ended.

It is not, therefore, certain that an “ex-ante” allowance such as the one intended by Ofgem can be evaluated on a sound basis in due time. It may not be in the GB consumer’s best interest that such allowance cannot be reopened.

NBL is of the view that there should be a mechanism to re-examine residual allowances, two years after the commissioning of the project, and re-assess retrospectively. This would not imply reopening the PCR process itself, but only the specific allowances.

Question 2: Do you have any other views on the post-construction review for NeuConnect?

NBL has no other comment.

NeuConnect

Appendices

APPENDIX A	**Further considerations on land cost disallowance - CONFIDENTIAL**
APPENDIX B.1	**FTI-CL - NeuConnect - GB socio-economic welfare - 19 May 2022**
APPENDIX B.2	**FTI-CL - NeuConnect - GB socio-economic welfare - 19 May 2022 - CONFIDENTIAL**