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Dear Ikbal,

Response to the statutory consultation on the Post Construction Review of the NSL interconnector to Norway

National Grid Interconnector Holdings Limited (NGIH) welcomes the opportunity to respond to Ofgem's minded-to position on the Post Construction Review (PCR) of the NSL interconnector project and the statutory consultation on consequential changes to the special licence conditions of National Grid North Sea Link Limited (NGNSL).

NGIH is the legal entity within the National Grid group responsible for interconnector development and the management of existing operational interconnector businesses. NGIH comprises a 100% investment in NGNSL, National Grid IFA2 Limited (NGIFA2) and National Grid Viking Link Limited (NGVL); together with a 50% interest in BritNed Development Limited and Nemo Link Limited. NGIH represents NGNSL, NGIFA2 and NGVL, which are also regulated under the cap and floor (C&F) regime.

As the regulated route for electricity interconnector development in Great Britain (GB), the C&F regime represents a significant and positive regulatory innovation. The regime has successfully incentivised the development of GB electricity interconnection capacity and delivered benefits to consumers through enhanced security of supply, access to lower electricity prices and has already facilitated reduced transmission charges through early above cap revenue payments made by Nemo Link and NGIFA2. In addition, interconnectors provide a vital tool to decarbonise the energy system, by allowing renewable energy to move from where it is produced to where it is most needed. In this context, the successful implementation of the C&F regime is critical to allowing those benefits to GB consumers to be realised.

<u>PCR Cost Assessment</u>

We are pleased that in its minded-to PCR allowances, Ofgem has assessed that the vast majority of the costs submitted by NGNSL for developing, constructing and operating NSL are economic and efficient. Ofgem's proposed cost disallowances total £6.8m (in 2015/16 prices), representing ~0.5% of the total GB share of project costs that we submitted in the PCR for NGNSL. Included within this £6.8m is a £3.1m disallowance for Delay in Start-Up (DSU) insurance, which is a category of costs that Ofgem has an established policy position (to disallow) in the Final Project Assessment (FPA) and PCR under the cap and floor regime. Of the minded-to disallowances to capex, opex and repex, we do not agree with Ofgem's assessment that the proposed reductions to NGNSL's submitted costs are justified on efficiency considerations and have responded to these in Appendix 1.

<u>Treatment of Commissioning Power in Capex Costs</u>

In Ofgem's decision on the NSL FPA, the estimated costs (£0.6m) at that time of commissioning power were disallowed from the cap and floor. Similarly, we note that in NGIFA2's PCR, commissioning power costs of £8k were disallowed and, in its supporting statement, Ofgem commented "any positive revenue earned would be excluded from the cap and floor regime".

Within NGNSL's PCR submission is a line item for commissioning power representing a benefit (negative cost) to the total capex costs. While NGIH continues to consider it appropriate to include commissioning power within the scope of the cap and floor construction costs, for consistency of treatment, we suggest that this should be removed from the cap and floor calculation.

Special Licence Condition 5: Treatment of Delay in Start-Up Insurance in the Cap and Floor Regime

As mentioned above, Ofgem has taken a consistent approach that DSU insurance should be disallowed from the costs included in an interconnector's cap and floor levels. Ofgem has also stated that any DSU insurance proceeds are, correspondingly, not within the scope of the cap and floor regime[1]. For the avoidance of any ambiguity on this point, and to ensure that the licence drafting reflects Ofgem's policy position, we propose that the Receipts from Insurance (RI_t) definition within Special Licence Condition 5 is amended to explicitly omit any proceeds from DSU insurance. We would be happy to work with Ofgem on proposed drafting to capture this.

Corporation Tax Rate Position

The current treatment of corporation tax, applied in Ofgem's minded-to PCR position, results in cap and floor levels on returns that are not commensurate to the magnitude of costs faced by NGNSL.

NSL took Final Investment Decision (FID) in March 2015, the published corporation tax rate at that time was due to be set (from April 2016) at 20% which was used to calculate the preliminary cap and floor levels at FPA. In the NSL PCR consultation, Ofgem has continued to apply the corporation tax rate of 20% in its calculation of the final cap and floor levels. As of April 2023, the corporation tax rate has increased to 25%. This deviation represents a significant shortfall in the tax liability assumed in the calculation of NGNSL's allowed annual returns versus the known tax burden that will be faced in operations.

Incorporating a mechanism into the existing cap and floor model, to periodically vary corporation tax and capital allowance rates to reflect actual rates, represents an ideal approach to the treatment of these parameters. Such a mechanism would constitute a fair and symmetrical treatment of tax for both licensees and consumers and would avoid arbitrary gains or losses arising from timings of fixing a project's tax allowances. However, if the corporation tax rate is fixed for the regime duration, we do not agree with the principle that it should be locked at Final Investment Decision (FID), that being a rate that is applicable at a point in time before construction, and years ahead of the asset entering operations.

We propose that, if a fixed corporation tax rate assumption approach is to be used, it should either be based on:

(1) The prevailing view of HM Treasury corporation tax rate(s) for the duration of the regime period, at the time that Ofgem publishes the PCR consultation (i.e. the point in time when the cap and floor levels are being finalised); or
(2) The prevailing corporation tax rate on the date at which the interconnector entered operations.

[1] Decision – FPA of the Viking Link Interconnector to Denmark, para. 3.36: *"In the event that Viking Link do claim their DSU insurance, any revenue from this would not be considered part of the cap and floor…"*

Either of the above options would provide a more representative snapshot of the corporation tax rate applicable to the operational interconnector (than the rate that was prevailing at FID, years before entering operations).

If you would like to discuss any of the contents of this response, please contact Sally Lewis (Sally.Lewis@nationalgrid.com).

Kind regards,

Ruben Pastor-Vicedo
National Grid North Sea Link Limited

Appendix 1 – NGIH's position on Ofgem's minded-to disallowances

Our position on the proposed construction disallowances is as follows:

- Converter Station - Snow Guard (£0.2m): In the engineering design of the assets, throughout the development and construction of NSL, the project team adopted the approach that the interconnector's constituent parts should be specified to a standard that is safe, fit-for-purpose and enduring, but also economic and efficient, that is, the design avoids unnecessarily 'gold-plated' solutions. As such, there is a balance in the design phase that aims to specify requirements to a sufficient standard to meet requirements while not introducing excessive specifications beyond what is required, at a higher cost. In this case, the original converter building design was specified to the established standard, at that time, to withstand the known weather conditions in that region. During the construction phase, experience at a similar Statnett site highlighted a potential risk with the design, that could result from accumulated snow on the building roof. Consequently, additional design work was undertaken to modify the converter station roof and mitigate this risk. We consider that NSL's approach to this process was responsible and prudent and do not agree with Ofgem's view that the associated cost should be disallowed.

- Delay in Start-Up (DSU) insurance (£3.1m): We continue to consider that DSU insurance could provide significant benefits to consumers, if treated within the scope of the cap and floor regime. However, we recognise that Ofgem has taken a consistent position that neither the cost of this insurance, nor any insurance proceeds from it, are in the scope of the cap and floor regime.

Our position on the proposed operational cost disallowances is as follows:

- Opex - Marketing and Website Costs (£0.4m): We welcome Ofgem's view that NGNSL is taking an efficient approach towards its marketing costs by sharing costs across the wider NGV portfolio where possible. However, we disagree with Ofgem on the point that NGNSL does not require specific marketing, which we consider is critical to developing and maintaining a competitive presence to attract and retain market participants. Both NSL's product offering, and its connecting market (the Nordic market), mean that it has a sufficiently unique model compared to the NGV portfolio to justify its own marketing. Customers frequently specialise in certain products and markets, as such it is appropriate to take a targeted approach to marketing NSL. NGNSL seeks to promote the NSL brand through maintaining a dedicated website, communications, marketing material and promotion publications.

- Opex - Other costs (£1.2m): We have engaged bilaterally with Ofgem on this cost category during the PCR assessment process and have no further information to share as part of this consultation response.

- Repex - Control and Protection (£2.0m): NGNSL's repex estimates were based on detailed engagement with NSL equipment manufacturers. For Control and Protection those cost estimates consisted of a range of costs, for which we took a balanced view and used the middle of the range. Ofgem made an adjustment to allow the bottom of the range of Control and Protection costs. We do not consider that NGNSL's cost estimate for this category was above an economic and efficient level of expenditure.