

JOINT OFGEM/CREG CONSULTATION: NEW ELECTRICITY INTERCONNECTOR REGIME

BRITNED RESPONSE

GENERAL REMARKS

- 1 BritNed Development Limited (**BritNed**) welcomes this opportunity to respond to Ofgem's and CREG's joint consultation on proposals for a new cap and floor regime for electricity interconnector regulation (**Consultation**). This response focuses on the new cap and floor proposal as an enduring regime rather than specifically as the regime governing the NEMO interconnector (as the pilot project).
- 2 As recognised in the Consultation document, increased electricity interconnection between Britain and continental Europe is highly desirable. It will help in ensuring that Britain is an integrated part of the developing European internal electricity market, extending the benefits of increased competition (via the ability to arbitrage between the electricity markets on either side of an interconnector). It will also support the deployment of increasing volumes of variable renewable energy sources, thereby enhancing the security and quality of electricity supply between Britain and other EU countries and securing lower energy prices for the region. BritNed welcomes the recognition in the Consultation that the realisation of these benefits requires a clear, stable and predictable regulatory framework which creates the right investment incentives at the outset and during the lifetime of existing and new interconnector infrastructure. BritNed also welcomes the commitment in the Consultation to ensuring that the regulatory framework for interconnectors is non-discriminatory as between existing and future interconnectors (in particular in the North Sea, which is BritNed's primary focus).
- 3 The transition to an energy system based on increased reliance on renewable resources requires multi-billion euro investments in additional subsea HVDC interconnectors across Europe, some of which investments have already been made (e.g. BritNed interconnector) and many of which will need to be made over the forthcoming years (including but by no means limited to the NEMO interconnector). Subsea HVDC interconnectors present considerably higher commercial and operational risks, compared, for instance, to traditional onshore grids. To incentivise optimal investment in existing and new infrastructure, it is essential that the regulatory framework enables developers/investors to identify upfront and on an ongoing basis (for the lifetime of the asset) with sufficient predictability (i.e. "a clear, stable and predictable framework") the level of financial, commercial and regulatory risks inherent in building and operating a given interconnector. Optimal investment levels are also only likely to be achieved if the regulatory framework provides a sufficient guarantee that the commercial rewards available to developers/investors over the lifetime of the asset will be commensurate with the investment and ongoing operational risks borne by the developer/investor. Finally, BritNed would appreciate further certainty that the regulatory framework itself will not place certain interconnectors at a competitive disadvantage to other interconnectors but will rather provide a level playing field between interconnectors.
- 4 BritNed has invested heavily up front so any further confidence given by the outcome of this Consultation would be gratefully received..
- 5 In BritNed's response to Ofgem's January 2010 consultation, we identified the difficulties in structuring investment in interconnector infrastructure between Britain and a continental European country with a very different regulatory approach (generally

favouring a socialised model, with the interconnector forming part of the regulated asset base and owned by the national TSO). Although collectively the national Regulators, relevant TSOs and BritNed itself have so far managed to overcome the many hurdles that this situation gives rise to, the considerable expense (both in terms of time and effort) is something which should be considered very carefully.

In seeking to address head on the challenge of ensuring that the regulatory approach on both sides of future GB-continental Europe interconnectors is aligned, mutually consistent and creating the right investment incentives, Ofgem and CREG are pursuing an essential task needed to support the ongoing efforts to align the regulatory approach in GB and other parts of the EU and to increase levels of market coupling.

BritNed is very encouraged and optimistic by this Consultation which should highlight and ensure the merchant model is properly catered for in the broader evolution of interconnector regulation within the EU. BritNed welcomes all the ongoing efforts at harmonising various aspects of the regulatory regime across the EU (e.g. harmonisation of interconnector access rules between and across regions; work on the various unified codes)

- 6 BritNed would welcome clarification from Ofgem/CREG to what extent these proposals have been discussed and/or approved by (even informally) with the European Commission or, if this has not happened, whether and at what stage Ofgem/CREG propose to engage in such dialogue. .
- 7 Finally, the Consultation is clear that Ofgem hopes to develop the cap and floor regime into “*an enduring regime to regulate future interconnector investment that would co-exist alongside the merchant-exempt route*”. To the extent that this statement confirms that the Consultation proposals will not undermine existing exemptions (including BritNed’s), BritNed welcomes this. However, BritNed also welcomes the clear statement in the Consultation that the electricity interconnector regulatory regime which results from this Consultation should be on a level playing field as between existing and future interconnector projects (paragraph 6.2).

Question 3.1: Do you agree with principles of the regulated regime we have identified?

- 8 Yes. In particular principle 5, as it affirms the need for a level playing field between existing and new interconnector infrastructure (and BritNed will be keen to understand, as these proposals are developed and clarified, how the evolving regulatory framework for electricity interconnectors may impact on and/or create new opportunities for the BritNed interconnector).

Question 3.2: Are there any other principles that should underpin the new regime?

- 9 At this point, BritNed is not proposing any additional principles.

Question 4.1: Is the cap and floor model the right approach to meet the principles of the new regulated investment regime for sub-sea interconnection? Are there any alternative approaches that we should be considering?

- 10 A cap and floor model does appear to meet the principles – this will of course depend on the levels at which the cap and floor are set and the other parameters of the regime as applicable to any particular interconnector (such as duration of assessment period,

whether assessment is cumulative or distinct, the reference variable (IRR, revenues, profits) and so on).

- 11 BritNed supports the proposal of a floor. In principle, it does make sense that, if the interconnector operator's commercial returns are capped, then its financial downside exposure should not be unlimited. The Consultation has correctly identified that the existence of a floor should reduce the developer's costs of capital (during the commercial lifetime of the interconnector), allowing the investors to take a more long term view, and provide protection against the risk that potential changes in national or European legislation (e.g. changes in the congestion management guidelines) could adversely affect the business case of the interconnector.

Question 4.2: Do you see benefits in introducing a cap and floor regime with profit sharing arrangements? Do you have views on how a profit sharing approach could work?

- 12 BritNed understands that The Consultation's proposal is aimed at retaining the benefits of the merchant interconnector model, "*which is to leave interconnector developers to choose the appropriate size, timing, location and technology for the interconnector and managing the construction and operational risks arising, whilst providing a regulatory framework that includes strong incentives for capital efficiency*" (paragraph 3.2). BritNed sees this as a way of providing a good oversight for a merchant operator to be in a better position to balance its risk and rewards therefore giving further insight when making investment decisions,

Question 4.3: Do you agree with the potential risks of the new regime identified? Are there any other risks or issues we should be taking into account?

- 13 The risks identified in the Consultation seem to BritNed to be more likely to arise in a situation where the cap is activated or close to activation, while in a scenario where there is a realistic prospect of the floor being activated during a given assessment period, other factors (such as reputational damage in the event the interconnector operator is perceived to be engaging in the identified undesirable behaviours) would in any event be more likely to mitigate the risks (and this is likely to be of increasing relevance as more interconnectors come into commercial operation, affording users more choice).

Question 5.1: Do you agree with the proposed design parameters of the cap and floor mechanism? Are there any other parameters we should be taking into account when designing the cap and floor mechanism?

- 14 BritNed agrees that all the design parameters referenced need to be fully considered.
- 15 The Consultation suggests (e.g. paragraph 4.7) that the design parameters for any given interconnector project will depend on specific project risks, which could result in different interconnector projects being subject to quite different cap and floor regimes. We ask that Ofgem and CREG are mindful of the potential this might have to distort the level playing field between interconnectors. BritNed is very encouraged that Ofgem appears to be alive to this issue (as indicated by paragraph 6.2).

**Question 5.2: Do you have a preference for the options presented under each parameter?
Do you have a preferred combination or straw man proposal for a cap and floor design?**

- 16 BritNed welcomes the view that the regime, and in particular the floor component, should persist for the lifetime of the interconnector asset, given the significant on-going commercial and operational risks that will continue throughout the asset lifetime.
- 17 The paramount importance of certainty and predictability when making the investment decision would seem to us to favour a constant cap-and-floor and we can see merits in some flexibility to address exceptional and unexpected issues.
- 18 Whatever the reference (revenues, profits or IRR) for levying the cap/floor is, BritNed feels it is important from its recent experience that losses resulting from eventualities such as imbalances and curtailment (in particular where capacity is contracted on a financially firm basis) are fully taken into account.

Question 5.3: Do you think the additional incentives should be introduced to encourage desirable outcomes under the regime?

- 19 BritNed would consider two-way incentives which not only penalise underperformance but also reward out performance.

Question 6.1: Do you agree with Ofgem's intention to use the cap and floor regime for future sub-sea DC interconnection in GB?

- 20 BritNed agrees that a cap and floor regime which creates the right investment incentives should be available for future interconnectors, provided a level playing field is maintained as regards existing merchant interconnectors.

Question 6.2: Are there any key issues we should be taking into account when developing the process for evaluating new projects?

- 21 BritNed is supportive of the principles underpinning the proposed new cap and floor regime for electricity interconnectors.
- 22 BritNed will be keen to understand, as these proposals are developed and clarified, how the evolving regulatory framework for electricity interconnectors may impact on and/or create new opportunities for the BritNed interconnector.