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Europe Strategy
Ofgem
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London
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Sent by e-mailed to: Brice Libert nemo@creg.be

2 September 2011

Dear Emmanouela,

Cap and floor regime for regulation of project NEMO and future subsea interconnectors

This response is jointly on behalf of EDF Energy and SPE-Luminus. We welcome the cooperation between the two national regulators and broadly support the proposals.

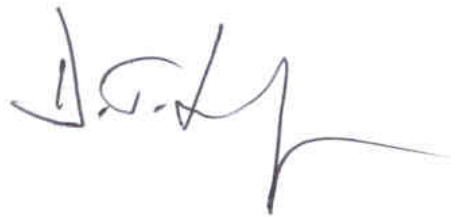
EDF Energy would like to make the following observations concerning the proposals of Ofgem and CREG:

- Ofgem and CREG should consider the extent to which the proposed mechanism will balance the risk between investment in the asset and the consumers who effectively guarantee the project's viability. From this perspective the development of a cap and collar mechanism should equitably share the allocation of risk between the two groups.
- The incentive scheme in some of the suggested options for reform will not necessarily encourage utilisation of the interconnector, as the cap will effectively become a revenue target. If this happens, excess revenues can be earned through restricting capacity until the revenue cap has been reached. This might be a convenient and indeed logical strategy for an Interconnector Operator (IO). The operator need not physically limit capacity to restrict supply, as it could do this commercially by offering excessive terms and conditions, poorly designed products or credit arrangements.
- Ofgem and CREG should also consider the extent to which the proposed mechanism will impact on existing or future merchant interconnection. We note that the risk / reward profile will fundamentally change as interconnector capacity increases through new investment. Furthermore, wholesale arbitrage between the UK and continental Europe will change over time, not just for primary fuel prices but also as a result of Government energy policy changing the opportunities available for trading. The banding approach as it is proposed will have to consider the issue of significant step changes in the cap and collar values when projects come on line.

- Interconnection effectively competes with generation for the provision of electricity, and so, if there is any subsidy in the form of a collar which guarantees the viability of the project, then the impact of the subsidy will need to be considered.
- The developments of the cap and floor mechanism will of course only be effective if regulators are able to accurately determine the actual values used. If incorrect this may require a re-opener to adjust revenues.

Our detailed response is set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries please contact my colleague Nigel Edwards +44 (0)20 3126 2506, or myself.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'D. Linford', with a long horizontal flourish extending to the right.

Denis Linford
Corporate Policy and Regulation Director

Attachment

Cap and floor regime for regulation of project NEMO and future subsea interconnectors

Response to your questions

CHAPTER: Three

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

The principles defined in the document are sound.

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

We agree with the principles outlined in the document. However, we would add:

- An explicit objective for interconnectors to increase cross-border trade.
- Recognition of the value of the enhanced security of supply interconnectors provide.
- A principle that requires the interconnector operator to make available as much physical capacity as possible.
- A principle that guarantees equity across different generations of interconnectors (as the risk reward profile will differ between the first and the last interconnector).

CHAPTER: Four

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?

It is not so much the principle behind the cap and collar that will determine its success. It is the fundamental need for the interconnector in the first place and Ofgem/ CREG's ability to correctly set the cap and collar.

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?

We see the key benefit of profit sharing, as it allows a more targeted allocation of risk/reward.

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?

We agree with the potential risks identified in the document. We would add the cap and collar mechanism has to be seen in the context of bidding behaviour in the capacity

auction process in the first place. The mechanism could potentially encourage strategic behaviour if firms know that over-recovery by the TSO will lead to discounts elsewhere in their transmission charges (2.4 p11).

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?

See table 1 below. In addition:

- We would support combining a cap and collar with a sharing factor. We recommend a 50/50 split in revenue for neutrality between consumers and Interconnector Operators (IOs).
- Recommend setting the collar at the cost of debt (say 4%) and the cap at say 3 times cost of debt for cap (say 12%).

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

We strongly recommend an availability incentive. The incentive scheme as it is proposed will not necessarily encourage interconnector utilisation, as the cap will effectively become a revenue target. If this happens, excess revenues can be earned through restricting capacity until the revenue cap has been reached. This might be a convenient and indeed logical strategy for an inter connector operator. The operator need not physically limit capacity to restrict supply as it could do this commercially by offering excessive terms and conditions, poorly designed products or credit arrangements.

CHAPTER: Six

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?

A natural response would be to change the bands for each project. This creates the problem of regulatory risk, as different interconnectors will be working under different incentive regimes for what could be viewed a homogenous product. Alternatively any readjustments of cap and collar levels to existing interconnection as new projects are commissioned would be equally problematic for the investor, but may make regulatory sense. Differences in treatment of interconnectors would open up to charges by different operators of unfairness or even the regulatory process distorting competition between interconnectors, coupled with the potential for appeals under competition law by an aggrieved IO.

CHAPTER: Five

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?

Table 1 – EDF Energy preferences for design parameters

| Parameter | Choice | Rationale |
|---|---|--|
| How long does the cap and floor regime persist for? | Lifetime of interconnector asset | The key uncertainty is the auction revenue long after finance has been repaid |
| How often is performance assessed against the cap and floor? | Yearly | Return yearly to align with accounts, which should be produced consistently each year |
| How is the assessment for each period treated? | Discrete | We would argue for one financial year |
| Are the caps and floors re-set? | Yes, periodically | Yes as per need, when circumstances have changed making original settings unfair or untenable |
| Does the cap and floor level change over time or remains constant? | Variable | We want sharing scheme to remain stable until a known reset |
| If the IRR approach is used, how is the project value determined? | Depreciated asset or Expected value asset | Discount rate cost equals revenue |
| Distance between the cap and floor? | Wide | As revenue will change with auction round |
| Approach to symmetry for the cap and floor? | Asymmetric | Incentive to invest should be linked to supply and demand fundamentals so would prefer a slightly lower collar |
| Treatment of revenues within the cap and floor? | Shared between developers and consumers | Agree |
| Any additional incentives? | Yes, availability incentives | Yes – see 5.3 |

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

We observe that:

- The risk profile for the first is fundamentally different from the second, third or fourth projects. This requires a different risk and reward profile for each project regardless of the regulatory regime.

- Furthermore, depending on the weighting given to encourage investment vs consumer risk, it would be possible to change the fundamental level of funding in either direction represented by the steps in figure 1 to accommodate changing uncertainties associated with the project.
- As more projects are commissioned, so the scope for over-recovery declines as there is fundamentally more capacity available. Equally, the first project is likely to over-recover, as capacity is scarce even if the underlying demand is there.
- Therefore, the competitive process will limit the amount of auction revenue regardless of the band-width set by the regulator.
- By tightening refund and recovery bands, consumers benefit as they are less exposed to project risk. Equally if the recovery bands are lowered, consumers are more likely to be refunding the developer. The reverse is true for developers.
- Inevitably policy will move between these two extremes. Setting an absolute limit for refund and recovery creates a payment cliff edge for both consumer and developer interests.

EDF Energy
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Figure 1 Issues Associated with Setting Sharing Factors and the Impact of New Projects

