



**Ofgem/CREG Consultation on a Cap and floor
regime for regulation of project NEMO and future
subsea interconnectors**

A Response by EirGrid

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Introduction

EirGrid plc. welcomes the opportunity to comment on the joint consultation paper by Ofgem and CREG on a cap and floor regime for regulation of project NEMO and future subsea interconnectors. (Ref: 86/11). EirGrid plc. is the Transmission System Operator of the transmission systems in Ireland (EirGrid) and Northern Ireland (SONI), the Market Operator of the Single Electricity Market (SEMO) and the Interconnector Owner of the East West Interconnector between Ireland and Wales (which will operate under a fully regulated regime). In addition SONI is currently the Interconnector Operator and Interconnector Administrator for the Moyle Interconnector.

Achieving 'Optimal' Levels of Investment – the Contribution of Cap and Floor

EirGrid would like to see in place interconnector arrangements which are congruent with the operation of the transmission system, facilitate well functioning markets, provide appropriate incentives for interconnector owners and operators and protect consumers. EirGrid also wishes to see an 'optimal' level of interconnection developed. Indeed EirGrid is investigating, and is charged with investigating, the development of future interconnection from Ireland. It is quite possible such interconnection will be with GB.

It is important to recognise that an 'optimal' level of interconnection incorporates wider environmental and societal benefits (facilitation of renewables, security of supply etc.), not all of which are capable of being captured in congestion rents. It is therefore a classic externality problem and where externalities exist regulation and market intervention have a role to play.

Moreover interconnectors are long life sunk and largely irreversible investments. They therefore in the absence of support have characteristically higher hurdle rates for undertaking investment given the uncertainty concerning the regulatory regime, market developments and indeed the effect of further future interconnection.

The cap and floor approach outlined in this paper represents one approach to providing intervention necessary to overcome both the externality problem – by ensuring consumers contribute to the benefits they receive which are not captured in congestion rents – and the higher hurdle rate for uncertain investment – by removing some of that uncertainty through the application of a floor. If designed appropriately it could therefore provide the necessary support to ensure interconnection is developed where it is to the ultimate benefit of customers. However, a fully regulated approach – effectively one where the cap and floor are set close together and where the interconnector is subject to the Congestion Management Guidelines which are designed to enhance trade and ultimately protect consumers – should not be ruled out.

Contribution from Consumers under a Regulated or Cap and Floor Regime

The primary risk and benefit sharing under the proposed cap and floor approach is between consumers and the interconnector developer. The extent to which the new cap and floor regime more closely adheres to the merchant or regulated model going forward depends on how wide or narrow the cap and floor is set with the narrower the difference between the two the closer the model to that of a fully regulated entity.

Where consumers do provide that support it is important that revenues earned from interconnection are also capable of being employed to the benefit of consumers. To that end EirGrid supports and welcomes Ofgem/ CREG's interpretation of the Use of Revenues requirements/ Statement and would note this in the context of the forthcoming requirement to produce a statement for the approval of Ofgem in the context of the East West Interconnector.

However, a secondary consideration to the underlying balance of risks between consumers and the interconnector developer must be the basis upon which any consumer support will be provided from the respective jurisdictions to which the interconnector is connected. Ultimately removal of congestion bottlenecks should give rise to price equalisation between markets. Overall societal benefit (on both sides of the congestion) should be greater but the benefits may not be evenly distributed. If price equalisation is reached congestion rents themselves will disappear. These should be considerations in determining the burden sharing and basis of support for both regulated interconnectors, and for those subject to any proposed cap and floor regime.

The East West Interconnector which is currently being developed by EirGrid was developed in the absence of this consultation and a basis for underlying customer support and burden sharing. Nonetheless, both Irish and GB customers benefit. Once an arrangement is developed whereby it can be determined how best customers should support regulated interconnection we would wish to engage with you to discuss the implications for the East West Interconnector and the appropriate contribution of both Irish and GB customers.

Whatever, the regulatory regime which applies it must be co-ordinated. Those who are supporting an interconnector development should have a particular say in the arrangements which apply. With the introduction of a cap and floor regime there will be no uniform regulatory approach to interconnection in GB. A merchant model has been applied to BritNed and the merchant approach has been the standard approach to date in GB. The EirGrid East West Interconnector will link GB to Ireland in 2012 and will operate under a fully regulated model supported by the Irish customer. The cap and floor model will effectively introduce a third regulatory regime for interconnectors connecting GB to neighbouring countries.

While this regime is welcome it should not necessarily be applied without further consideration in each and every case. Ultimately the regulatory regime which is appropriate should be considered between the two relevant Regulatory Authorities, the two TSOs with whose systems the interconnector will be connected and any prospective interconnector developer.

Principles Underpinning the Regulated Cap and Floor Model

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

EirGrid agrees with the general principles of the regulated regime identified in terms of looking to protect consumers and provide a sufficient return on investment for investors.

If there is commercial appetite for new interconnection and third party providers are interested in developing and funding new lines this should be supported as it serves to limit the exposure of consumers to the cost of the investment, whilst providing appropriate incentives to interconnector investors to maximise the efficiency of the link and earn an appropriate rate of return on their investment.

In the event that third party providers are not forthcoming and do not invest in new interconnection in sufficient quantity or within the required timelines to meet the requirements of the Energy Infrastructure Package to support the integration of renewables, security of supply and the completion of the internal energy market, then the fully regulated approach will need to be considered.

Under existing and future European legislation consumers are protected under a regulated approach regardless of whether the approach is cap and floor or fully regulated as there are clear provisions on the use of revenues and requirements for maximising available capacity. However, interconnector investors who are bound by the provisions of Regulation 714/2009 can only charge for capacity when an auction is congested. The risk to consumers under the regulated approach is that an interconnector will not be congested to cover the capital cost of the investment. Although a merchant regime with a cap provides protection to consumers it is likely to result in under-investment in interconnection. A cap and floor regime would serve to balance the risks between investors and consumers assuming the level at which the cap and floor is set is appropriate to incentivise new investment when it is needed.

The consultation considers that “regulatory treatment of developers should be coordinated between National Regulatory Authorities at either end of the shared asset”. This assumes that the cost of the asset is shared for all interconnections. While this is true for the NEMO project, EirGrid would note that the cost of the interconnector asset for East West is not shared at either end and is fully covered by the Irish consumer. Therefore the level of coordination by NRAs on the regulatory treatment of investors will not necessarily be the same across all interconnectors.

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

Interconnectors are subject to the principle of diminishing marginal returns. As revenues are earned via congestion rents it is likely that an interconnector first in and operational is likely to be congested and be profitable. As more interconnection is added the likelihood is that these will be uncongested at least some of the time, with the result that congestion rents are lower. This implies that as the level of interconnection increases the floor price would need to be higher to incentivise new investors to build additional interconnection to mitigate against the reduction in congestion rents.

On the other hand, policy and societal benefits (e.g. security of supply) should be reflected in the floor price. The first interconnector has a greater benefit than the next and so on until there is minimal benefit to society of adding additional interconnection. This suggests the floor price should be lowered accordingly as new interconnectors are added.

One of the questions raised in the consultation was whether additional incentives should be put in place in tandem with the cap and floor regime. EirGrid believes availability represents one such incentive and the level of availability can effectively affect the cap and floor parameters consistent with the benefits which will be received by consumers as a result of an interconnector’s availability.

Cap and Floor Regime – Some Further Considerations

The cap and floor regime raises a number of additional questions which need to be addressed.

- It is unclear to what extent future GB interconnections would be able to access EU funding and grants for new interconnectors if not fully regulated as per the European model.
- What will Ofgem's approach be to regulating different interconnectors connecting to GB with different regulatory regimes in place on each?
- The consultation notes that the implementation of a new regulatory regime would imply changes to interconnector licences. Currently there is a single set of Standard Conditions for all interconnectors connecting to GB. It is not appropriate to retrospectively change these based upon the introduction of a further and amended regulatory regime for new interconnectors and we therefore assume such changes would only be on a forward looking basis.
- Consideration would need to be given as to how compatible the cap and floor regime is with the current EU regulation(s) and with future network code(s), given that it is different from the accepted European model for interconnection?

Summary and Conclusion

We have set out above our primary points in relation to the proposed cap and floor approach. In summary:

- Any regulatory regime should support optimal levels of Interconnector development;
- The benefit and risk sharing between consumers and interconnector developers should be stable and understood. Moreover, consumer support should be proportionate to the benefits received;
- A 'one size fits all' approach is not likely to be appropriate. There remains a role for the fully regulated interconnector model which is that which is both preferred and dominant in a European context; and
- There are certain considerations or caveats which we would place upon the cap and floor approach which, while they would not rule it out, nonetheless need to be taken into account.