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Dear Emmanouela,

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

Thank you for the opportunity to respond to the above consultation. This response is made on behalf of the E.ON group.

We are generally supportive of the approach proposed for the NEMO interconnector and subsequent electricity interconnections, although we do not believe that the range between any caps and floors set under the regulations should be wide.

From our reading of the consultation document, Ofgem has decided to move away from the traditional merchant approach for interconnections with the GB market in order to address a number of issues, including:

- The requirements of European legislation, particularly those relating to the use of revenues from interconnectors.
- The concerns of the European Commission that a pure merchant approach would result in interconnections that were undersized in order to maximise congestion revenue.
- The reluctance of the European Commission to grant exemptions from licensing apart from in exceptional circumstances.

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- The desire to include existing European TSOs as possible development partners in future connections and who are precluded from participating in a non regulated capacity.

As one of the main concerns is the economic incentive to undersize assets under a merchant approach, we believe that this drives the choice of scheme parameters under this proposal to one that removes this incentive, which presumably means a more regulated return based method. Therefore, we believe that a scheme with a wide range between the cap and floors would be inconsistent with this aim. A regulated return approach should bring treatment of these assets more into line with that adopted for transmission assets within national transmission systems. This would appear to be appropriate as interconnectors are now formally classified as transmission assets, which is why they were recently removed from the GB charging base for transmission charges for instance.

Our answers to the specific issues raised are as follows:

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

Yes in general. However, we would qualify this in respect of the first principle regarding exposing developers to the market's valuation of interconnector capacity. We agree that this should mean that capacity is allocated on interconnectors in accordance with the value that the market places on interconnector access, either through an implicit or explicit auction mechanism. However, if the intention of this new regime is to act as a proxy for a regulated return approach rather than a more merchant approach relying on riskier congestion revenue, then allowing a wide exposure to the value that the market places on the capacity such as through wide caps and floors, would seem to be inconsistent. Instead, a relatively narrow cap and floor range might be more appropriate.

This still allows the capacity to be allocated in accordance with market value, with any surplus or deficit being shared through transmission charges of the TSOs at either end of the interconnections concerned.

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

No.

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?

As mentioned above, a regulated return is one approach which would seem to more closely meet the European legislative requirements which appear to be at the heart of why a pure merchant model is not deemed acceptable, and why this new approach has been proposed.

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?

Presumably, profit sharing would be considered as an incentive to ensure that the availability of the interconnector is maintained when the cap is breached or is close to being breached. We would expect that this model would include loss sharing too for instances where the performance is close to or below the floor to ensure that the incentive is maintained then also. This could simply take the form of the interconnector owner being exposed to a proportion of the payments which would be made under the cap and floor arrangements, so that TSO domestic charges are not fully affected.

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?

Yes. They appear to relate to concerns regarding incentives to honestly report costs or operate the interconnector to what may be regarded as good industry practice. We would question whether or not these concerns would exist under a regulated approach and if not whether a regulated approach may be a preferable option.

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?

The possible design parameters all appear to be represented.

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?

If the aim is to avoid a merchant approach and provide a solution closer to a regulated model, then the parameters should be set in an appropriate manner. In our opinion this would mean the following parameter options being chosen.

- 1. *How long does the cap and floor regime persist for?*** Presumably, this would be for the life of the project in order to act as a proxy for a regulated approach, unless there was a move for all regulated interconnections to be granted exemptions in the longer term.
- 2. *What is the cap and floor levied on?*** We note that the revenues of Britned have been capped on an Internal Rate of Return basis and for consistency this approach could be adopted for NEMO. This approach may require a high degree of involvement from the relevant regulatory bodies, but this would presumably be no higher than that presently required for existing regulated interconnectors and onshore transmission companies.
- 3. *How often is performance assessed against the cap and floor?*** The assessment should be made to minimise the possibility of disruptions to onshore tariffs. This might

mean an annual assessment against caps so that large surpluses or deficits have less time to develop. The timing should ensure that the effects can be accounted for in local tariffs within the normal tariff setting timescales, to avoid mid-term changes in prices which are very disruptive to users and customers.

- 4. *Is the assessment for the defined period done on a discrete or cumulative basis?*** It is unclear to us how a cumulative assessment would be undertaken based on the information given in the consultation document. Therefore, a discrete assessment for each period is the only option we are in a position to support at this point.
- 5. *Are the levels re-set? Does the cap and floor level change over time or remains constant?*** One issue with an IRR approach to capping is that assumptions can change through time. It would therefore be appropriate to adopt an approach similar to that used for onshore transmission companies and to assess and adjust these parameters on a periodic basis. The periods could be similar in length as those for onshore price controls, but there is no obvious reason why they would have to align perfectly.
- 6. *If the IRR is used, how is the project value determined?*** We have no particular view on this issue.
- 7. *Narrow vs. wide range.*** As we mention above, a narrow range would be a closer proxy for a full regulated approach.
- 8. *Symmetrical vs. Asymmetrical*** The choice between symmetric and asymmetric ranges should be based on an assessment of the risks around the central allowed return. Of course, the narrower the range, the less of an issue this becomes.
- 9. *Profit sharing within the cap and floor range*** A number of different approaches could be taken within a wide range. A narrow range reduces the scope for this.
- 10. *Availability incentives*** As discussed above some form of profit and loss sharing arrangements when the cap or floors takes effect may maintain the incentives on interconnector owners to make capacity available to users.

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

Please see our response to 4.2 and point 10 in our response to 5.2.

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?

Subject to the responses on parameters given above, yes.

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

No.

I hope you find the above response helpful. Please contact me on the above number in the first instance should you wish to discuss this further.

Yours sincerely

Paul Jones
Trading Arrangements