Réseau de transport d'électricité

2/9/2011

# OFGEM/CREG Consultation Ref: 86/11

# Cap and floor regime for regulation of project NEMO and future subsea interconnector

# RTE response

Réseau de Transport d'Electricité (RTE), the French Transmission System Operator, welcomes the opportunity to respond to the consultation on the "*Cap and floor regime for regulation of project NEMO and future subsea interconnectors*", launched by Ofgem and CREG and issued on 28th June on the OFGEM's website. RTE is ready to analyze to which extent a shared regulatory approach could facilitate the development of new interconnections consistent with the core principles of the EU electricity organisation (security of supply, network access,…).

RTE has no specific opinion about the NEMO project but wants to reply this consultation in the framework of chapter 6, titled "*Process for evaluation of new interconnector investments projects in GB*". OFGEM specifically considers that the "cap and floor" regime may be applied to other projects between GB and the Continent; some answers to this Chapter 6 may influence the coordination between OFGEM and CRE, the French regulator, regarding the development of a future common approach on any regulated interconnection between France and GB.

First of all, RTE would like to recall some elements regarding the French regulatory approach of interconnections (including congestion revenues) and efforts made by RTE for developing new interconnections,

- Since the adoption of the 1228/2003 EU regulation that has set a framework to the use of congestion revenues, France has known two regulation periods. From 2006 to 2008, CRE decided to allocate all congestion revenues to decrease the transmission tariff. Since 2008, these revenues are split into one part, up to € 202,9m (evaluated for a 4-year period), which can be allocated to future investments, and the rest which is used to decrease the French transmission tariff.
- Any interconnection investment is treated as any other type of investment. This means that investment on interconnections is included in the regulatory asset base and multiplied by the regulatory WACC, before being charged to users of the network

through the French transmission tariff. A specific mechanism is in place to prevent any double payment of new interconnections by the users' community (i.e. interconnections that would be financed through the tariff and through congestion revenues at the same time).

- In this regulatory context, RTE has largely contributed to the development of the interconnections with most of its neighbours. In particular:
  - On the eastern border (from Belgium to Italy), three 400 kV lines and one 225 kV were renewed and/or reinforced and two phase-shifters were installed. On this border, RTE is developing with Terna a 190 km underground HVDC line of about 1000 MW to largely increase the interconnection capacity,
  - On the southern border (with Spain), RTE and REE are building a 64 km long HVDC underground line that will double the transfer capacity between two transmission systems and RTE has also realized some other works of lower impact on the capacity.
  - On IFA interconnection, the DC converter substations are being renewed.

# CHAPTER 3

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

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

The proposed principles express the need to find the best solution that will maximise the social welfare of interconnected countries; therefore they must be examined in the light of the EU energy policy which is today the best expression of this social welfare. For electricity, it can be summed up by three challenges: a competitive market, a secured supply and a large integration of renewable generation plants. Most of the five principles developed in Chapter 3 are relative to the first challenge, competitive market. That is why the 5 high level principles which are displayed in this consultation should be extended to the three following ones referred in this documents principle 6, 7 and 8:

**Principle 6-The enhancement of the security of supply brought by new interconnections should be taken into account by the regulation,**

One has to remember that the original motivation at the end of the Seventies and at the beginning of the Eighties when planning to build the IFA interconnector was to increase the security of supply for France and GB.

This is also today one of the key-elements of justification for the construction of the new France-Spain HVDC interconnector, the INELFE project. As mentioned on the INELFE website[1] "*International interconnection is extremely important in order to assure the security of electrical supply in countries, since it allows exporting energy during periods of high production with low demand (for example, at night) and vice versa. It also enables importing electricity when there are sudden peak in demand or when a failure occurs in the electrical grid*."

**Principle 7-The ability to share renewable electricity between countries should be assessed and recognised,**

A large motivation for many of the major projects of new lines within Europe in the next decades comes from the necessity to transmit over long-distances large volumes of intermittent renewable electricity generation. A sustainable GB regulation on interconnections should include this new feature in line with the UK government commitments to support a green economy that are summed up in the document called "*Enabling the transition to a Green Economy*"[2]. In this document, the following table can be read:

| Government will… | Business could… |
|---|---|
| Encourage investment in infrastructure and ensure that infrastructure supports the green economy, including through the Green Investment Bank | Invest in infrastructure that will support the green economy. |

**Principle 8-For the protection of final consumers, the development of regulated interconnections must be coordinated within the global regulated electric system.**

In a social welfare approach, regulation should not isolate an interconnection project with the risk of limiting the cost optimization to this lonely case. On the contrary, the optimization of the global electric interconnected system in which it is inserted must be taken into consideration (in that way, any project of this kind could be analyzed within the framework of the Ten-Year Network Development Plan):

- The existence of a new interconnection will certainly modify the way the balance between offer and demand will be made in the different connected control areas,

[1]This principle of security of supply and the next one (principle 7) are detailed on **http://www.inelfe.eu/?Objectives&lang=en**
[2]https://online.businesslink.gov.uk/Horizontal_Services_files/Enabling_the_transition_to_a_Green_Economy__Main_D.pdf

- The construction of a new line will modify the flows on all the other lines especially in the onshore AC part of the network where flows are primarily dependent on physical rules and such new line may then induce additional investments to fix new potential congestions.

That's why RTE is quite astonished with chapter 3.2 stating alleged advantage of the merchant approach where it is written that "*the regulated regime aims to maintain one of the **strengths** of the merchant approach, 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*."

More specifically, RTE is quite concerned with "*to leave interconnector developers to choose the appropriate size, timing, location and technology for the interconnector*" and thinks that such a principle would lead to inappropriate investment decisions, like in the merchant approach. In its answer to 2010 OFGEM's consultation Ref 12/10 on electricity interconnector policy (question 3.1), RTE has already raised that: "one key aspect of new electricity interconnectors has not been addressed in the consultation document: the cost of upstream reinforcement on each side of the new interconnector (…). If those costs are borne by TSOs under their national regulation scheme, it basically means that they are passed on to final consumers (…) In the absence of any incentive scheme for investors seeking exemption for merchant projects to choose their location according to network capabilities, such costs [of reinforcement] could be important.(…) [With the regulated approach], TSOs will, on the contrary, seek to have new interconnectors located at the "right" places, in the view of minimizing upstream reinforcement costs. (…)". ENTSO-E, through its Ten-Year Network Development Plan, constitutes a central tool for TSOs to develop new interconnection capacity in a harmonious way throughout Europe.

# CHAPTER 4

**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?**

The cap and floor model presented in the consultation set out within chapter 4 does not allow catching accurately all the parameters and methodology that could be actually in force in such a model. For instance a very low cap could not be compatible with principle 3 as a very high

floor would not be compatible with principle 2. Nevertheless, a reasonable setting of these two parameters (and of all the other possible ones) would likely allow the cap and floor model to meet all the principles including the three new ones above introduced above, with a specific attention for principle 8, which is critical.

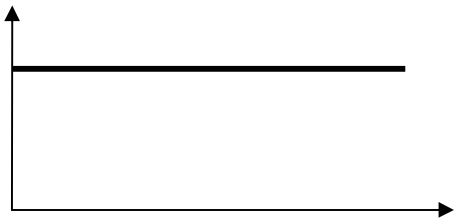
The present consultation also refers to the former one conducted by Ofgem in January 2010, in particular in its Appendix 3 where it is mentioned four options for regulating new interconnector investment.

Based on these schemes, which are alternative approaches of regulation, RTE has two remarks:

- There is a fifth option, today in force in France and in most of the EU countries :

5) Simply regulated

Return



This option would be equivalent to option 3 (regulated cap and floor), with the cap being equal to the floor.

- The fourth option (regulated),

In the document "*Ofgem's summary of responses to the consultation on electricity interconnector policy, September 2010*", answers to the consultation are discussed with the mention that only option 3 (cap and floor) and option 4 (regulated) were compatible with the current EU legislation. OFGEM reasons to discard option 4 appear in an "*Open Letter on next steps from Ofgem's consultation on electricity interconnector policy, September 2010*":

"*Whilst there are benefits from adopting a fully regulated approach, bringing GB in line with Europe, there are also disadvantages, such as reducing commercial incentives. On a practical level it would also signify a significant departure from our current approach, requiring several changes to our existing regime, which would take time to implement.*"

RTE understands that in the framework of a particular project such as NEMO, OFGEM and CREG propose to explore one of the two regulated models on which OFGEM consulted in 2010. Nevertheless, it can be underlined (see also answers to questions 6.1 and 6.2) that a more

global approach to other projects will require a deeper analysis of the regulated model (option 4) especially in the light of the principles of the present consultation that were not mentioned in the 2010 OFGEM consultation. It would be necessary to check whether this option 4 could also meet the principles set out by OFGEM in a way comparable to option 3.

**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?**

See answer to question 5.1.

**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?**

The first risk refers to the case where the operator is not incentivized to keep availability at a high level. Paragraphs 4.9 and 4.10 explain that this risk exists particularly when the cap or the floor are reached. RTE considers that the risk of the operator offering a capacity that is lower than technically available, also exists when the return lies between the cap and the floor and especially at the limit. Indeed, in some cases, capacity retention could lead to an increase in price spread and therefore higher revenues. In that situation, RTE understands OFGEM's concerns about this question.

Another risk mentioned in the consultation document is the fact that the proposed regime might result in an inefficient allocation of costs because "*an interconnector developer which also owns onshore transmission may (if for instance there are price caps applied to onshore grid activities) be incentivized to report costs related to onshore activities as costs of the interconnector business in order to maximize the total return of its onshore and interconnector activities.*" RTE would like to underline that, in a regulatory regime where the network is charged as a whole (i.e. without any distinction between the categories of assets), as it is the case in most EU countries, this risk does not exist.

# CHAPTER 5

**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?**

**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?**

RTE understands that these parameters need to be fixed on a case by case basis considering the peculiarities of a given project. As this CREG-OFGEM consultation aims at designing detailed parameters on the NEMO pilot project, RTE has no specific comments on these two questions that concern directly NG and Elia.

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

See answer to question 4.3.

# CHAPTER 6

**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?**

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

1. The OFGEM letter of September 2010 mentioned,

*"Project NEMO (the proposed interconnector between Belgium and GB) will be our "pilot project" in exploring whether a cap and collar model could be implemented in GB. (…) We intend to work up an initial proposal by the end of this year on which we would consult in early 2011.*

*Whilst we are using NEMO interconnector as our pilot project to develop our regulated investment regime, we do acknowledge there are other interconnector projects under discussion, such as additional links to France and Ireland and a new link to Norway. We envisage holding similar discussions with the relevant regulators to discuss if the cap and collar approach could be seen as a high level solution for other new non-exempt interconnectors."*

With questions raised in part 6.1 and 6.2, the present consultation goes beyond what was announced by OFGEM in September 2010 since it deals more widely with the cap and floor regime for all future sub-sea interconnections in GB.

It must be noted that the adoption of a pure "cap and floor" approach in France would necessarily have an very large impact on regulatory framework on allocation of auction revenues between interconnectors developers, future investments and consumers (through decrease of the transmission tariff) since today, according to the way the European regulation

714/2009, Art.16 is applied in France, only the last two allocations (future investments and tariff decrease) are currently allowed.

RTE underlines the necessity to take into account all regulatory situations in possible concerned countries before applying any regulatory regime to all new interconnections from GB.

2. RTE also believes that an open debate with EU authorities would be useful. In several paragraphs of the present consultation, the cap and floor regulated model is presented as a way to keep key characteristics of the traditional merchant GB approach. Especially in 4.5 and 4.6, it is clearly stated that the cap and the floor would be almost never activated, which therefore means a high cap and a low floor.

RTE wonders about the risk that a private developer (or anyone having an interest) may consider that, by applying the "regulated cap and floor model", NRAs actually grant a hidden exemption to TSOs, and thus take away investments opportunities from the unregulated sector to attribute them to the regulated sector. On this ground (defending a misapplication of Regulation 714/2009), a project developer seeking an exemption might then contest a decision of a NRA endorsing the cap and floor regulation before domestic courts or submit a complaint to the European Commission.