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Market Design and Regulatory Affairs

Your ref. EC10-PC-56
Your letter
Our ref.
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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 provided on behalf of the RWE Group of companies.

We retain our general preference for a purely merchant approach for interconnection to continue. The exemption process has been successful in adding significant amounts of new energy infrastructure, including Britned. It has enabled GB to be brought into the EU market coupling arrangements and has been the catalyst for removal of some of the distortive cross border charges.

However we recognise that the introduction of a cap and floor regime, to run alongside the typical merchant route, is a logical addition to the range of regulatory tools aimed at encouraging new electricity interconnection. Given the uncertainty created by EC requirements in the Britned case, the development of the EU target model for cross border allocation, the impact of low carbon generation and the Energy Infrastructure Package, we understand the need to modify the approach for the power sector.

We expect interconnectors to play an increasing role in delivering a balance between supply and demand across the EU as the impact of intermittent generation increases. Already, market coupling within and between the Nordic and CWE region has allowed for a more efficient market response to large variations in wind output.

In addition RWE expects that like Britned, all interconnectors whether exempt or not, should implement the EU target model and comply with all guidelines and network codes. This may be inconsistent with the business model of some future merchant projects and there needs to be an alternative route to delivering such projects. Clearly the capping of Britned's rate of return by the Commission already sets a precedent that may also put off potential investors.

An important aspect of the regulatory framework is consistency between the interconnector licence conditions (or their equivalents) in the connected Member States. This issue goes beyond the financial aspects and some additional con-

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sideration needs to be given to this in the regulatory regime with regard to licence conditions. It may be appropriate to involve ACER in such discussions in due course if a standard regulatory framework for subsea interconnectors is to be developed.

RWE does not support a cap and floor regime being developed for gas infrastructure. The current merchant regime has been highly successful in bringing forward pipeline and LNG investments which are now playing a very major part in the GB market. Given the increasingly complex interactions between the GB, European and global gas market, investment decisions in major gas infrastructure must continue to be taken on the basis of a commercial decision making process, rather than being regulatory driven. Of course there will still be some regulatory aspects to other investments in terms of developing entry\exit capacity and general reinforcement of gas networks within and between Member States. Ofgem should give a clear statement to the effect that the current merchant arrangements for gas infrastructure will continue.

Our response to the specific questions is included in Attachment 1. If you wish to discuss any aspect of our response, please do not hesitate to contact me.

Yours sincerely

By email

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ANNEX: REPLIES TO SPECIFIC QUESTIONS

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 five high level principles put forward by Ofgem are in general sensible. In particular there is a need for developers to retain some exposure to the market value of the project since this will lead to positive incentives to make firm capacity available. This is why we have favoured a merchant model for GB interconnection.

Consumers clearly need some protection against excessive returns if they, under a cap and floor mechanism, are implicitly taking on large elements of possible downside risk. However appropriate returns should also be available for improving performance in terms of additional and firmer cross border capacity and incentives should be retained in this respect.

Developers will clearly insist on a balance between their risk and reward. If not projects will not go ahead. Government and regulators will have to decide how important a project is at a strategic level when in discussions with potential developers about the balance between risk and reward. In this context it is also important that there is protection against retrospective changes to the regulatory arrangements and clearly coordination between regulators is highly important in this respect.

Finally RWE is in favour of an open regime for the development of new infrastructure. This is consistent with the approach taken in the OFTO regime.

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?
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?
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?

As discussed above RWE, on balance, would see the introduction of a cap and floor regime as a positive additional route for the development of infrastructure. If the design parameters are correctly tailored to each project a wider range of projects may potentially be supported.

The possible profit sharing approach is not desirable. This would introduce an added layer of complication and uncertainty and increase perceived regulatory risk. It also moves too far from the relatively successful merchant approach. Companies need to clearly understand the upsides and downsides of any particular project. Profit sharing on the upside without a similar measure on low returns (down to the floor) would introduce an asymmetry that many investors would probably find unacceptable.

Finally there are clearly risks of perverse incentives being created. The best regulatory tool in this respect is transparency and disclosure. Infrastructure operators should, for example, set out in advance their maintenance regimes and give reasons for any changes. Ofgem will need to be able to monitor behaviour and apply the appropriate competition law or market integrity processes, including possible sanctions. Similarly Ofgem should, as with Britned and IFA, ensure the timely application of guidelines including those enacting the EU target model.

Ofgem also needs to consider arrangements in the event of bankruptcy of the regulated entity. This was not necessary in the case of the merchant model since the asset would simply be sold. Under a cap and floor arrangement there would be questions around whether there would be a new framework and also around how the asset would be operated and rewarded in the meantime.

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

RWE considers that the proposed regime should not be too dramatic a departure from the merchant approach. In terms of the design parameters put forward, which appear to be rather comprehensive, longer term arrangements similar to RIIO principles and the OFTO contracts would be the most sensible route to follow.

- Arrangements should be consistent with the project financing timetables; the asset should be transferred to TSO control at the end of the period.
- An allowed revenue approach is more sensible than IRR
- Longer term arrangements with a large cumulative element are preferable. This avoids the problem of resetting the capital value
- Caps and floors should be constant, relatively wide and largely symmetric.
- As stated above we do not favour profit sharing within the cap
- We strongly recommend that project operators should be provided with performance incentives.

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 Ofgem should be taking into account when developing the process for evaluating new projects?

Ofgem should consider the use of the cap and floor regime for future projects after NEMO. Connection to the Nordic market is a logical next step which historically has never seemed possible under a purely merchant framework. Combined with the implementation of the EU target model, this would provide considerable benefits in terms of competition, market liquidity and security of supply.