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SUBJECT Consultation document Cap and Floor regime for regulation of project NEMO and future subsea interconnectors

Dear Mrs Angelidaki,

TenneT Holding B.V. ("TenneT Holding") appreciates being able to give its response to this consultation. TenneT Holding and National Grid plc. are, through their respective subsidiaries NLink International B.V. and National Grid International Limited, 50% shareholders in BritNed Development Limited. Our letter is a general response to the consultation from a shareholder's perspective and as such will not provide detailed answers to the specific consultation questions.

Cap and floor regime for regulating interconnector investment – General view

TenneT Holding supports and recognizes the ambition of the European Commission to deliver more cross border infrastructure to support the integration of renewable energy sources, contribute to security of supply across Europe and allow the completion of the internal energy market. This will require multi-billion investments in cross border infrastructure throughout Europe.

TenneT Holding is therefore pleased to see that the National Regulatory Authorities ("NRAs") of Belgium and Great Britain have taken a coordinated effort to introduce a new regulated regime towards interconnectors, next to the existing GB regime that in contrast to most European Member States has focused on the merchant route for investing in interconnectors. Principle 4 of the new investment regime also highlights increased coordination between the regulators which we strongly welcome. The need for coordination between the NRAs is of pivotal importance as insufficient coordination and harmonization can be considered as a barrier to timely interconnector investment. We would therefore like to understand how the proposed regime fits into European legislation and the national regulatory regimes of other countries and if the proposed scheme has been coordinated with the European Commission and a wider group of NRAs, such as the Dutch and the French regulators. One other coordination area that TenneT Holding has identified for the NRAs and that is widely considered a trading barrier on the BritNed link is the charging on interconnector flows in Great Britain (Balancing Services Use of System Charge and AC losses charge).

TenneT Holding is pleased to see that the NRAs acknowledge that a specific new regulatory regime is proposed for the NEMO pilot that can also be applied for new interconnector investment. The regime proposed recognizes that these interconnectors should be treated differently from traditional onshore grids. This is something we support as subsea DC-interconnectors have a higher risk profile than traditional AC grids. This means that investors are looking for a higher rate of return and/ or a regulatory regime that includes the right incentives for investment and operating efficiency whilst some of the risk is shared between developers and consumers.

It is not only the commercial terms where DC-interconnectors differ (e.g. rules for capacity allocation), also from an operational point of view there are some important different aspects that need to be addressed in future legislation and grid codes. These differences include DC transmission losses, availability levels, minimum flow conditions and flow change limitations/ ramping constraints.

We are prepared to undertake these investments based on an acceptable risk/return rate and under the right regulatory regime. The benefit of DC interconnectors is more than only the increased social welfare due to lower energy prices for the region and the creation of a level playing field for producers and consumers. DC interconnectors strengthen the grid system and provide the backbone infrastructure needed to establish the required security of supply whilst allowing more intermittent renewable energy sources into the system. Third party developers could be included into the regime as long as certain stringent conditions are met that are part of European and national regulation such as for example ownership unbundling and requirements for interconnector operation (e.g. target models for trading).

A key risk factor for any future investor in DC interconnectors is the convergence of market prices due to increased interconnectivity between markets. We therefore support Ofgem's notion that as the extent of interconnection increases between GB and other markets, prices may converge and it may be appropriate to evolve towards a fully regulated approach, under which the cap and floor may converge on regulated returns in the future.

Next to the market price difference risk is a second risk category that relates to topics such as firmness, national tariff treatment of interconnectors and European market integration activities (e.g. does any future coupling algorithm cater for the specific DC interconnector requirements?). In order to continue to attract the required investments the second category risks should be eliminated as much as possible whilst the first risk category is also being recognized and addressed. This should be adequately reflected in setting the right levels/ bandwidth of the cap and floor.

Assuming that the second risk category can be sharply reduced or eliminated, any cap and floor regime should allow for sufficient returns to cover the market price difference risks. It is envisaged that these returns will vary significantly on an annual basis (short term risk). In the short term, high revenue hours could make up for many hours without commercial gains (even for hours where the risk/reward balance is negative for the interconnector operator as the interconnector facilitates implicit flows at partial capacity thus completely converging prices whilst carrying the firmness risk). Merchant cables may have to make their earnings more

and more on the basis of the provision of flexibility to the system by selling it to anyone who needs it mostly. A liquid electricity market is therefore a pre-requisite for a merchant DC interconnector. The long term risk relates more to market integration efforts to establish the creation of one single energy market and a single price as well as investing in interconnector capacity based on other drivers such as the possible integration of renewable energy. Any cap and floor regime should therefore allow for short period peaks as well as annual fluctuations, but also be adaptable to the longer term trends.

The impact of the new proposals on existing interconnectors such as BritNed

The BritNed interconnector entered into commercial operation on 1 April 2011. The regulatory regime applied for BritNed is under this consultation referred to as the merchant-exempt regime with a revenue cap. Under this regime a floor is not part of the BritNed exemption, but a cap is. BritNed got an exemption with a cap on internal profitability of 1% above the expected rate of return at the time of the investment decision. This exposes BritNed to all downside risks, while the potential upside is capped and small.

The BritNed regulatory regime is based on the existing GB regulatory arrangements. The UK's Energy Act 2004 (as this act stood when BritNed applied for its exemption) requires any party participating in the operation of an interconnector in Great Britain be licensed to do so. A holder of an interconnector license is prohibited from holding a transmission, distribution, supply of generation license. The GB regulatory arrangements that require the separation between the interconnector licensee and transmission licensee have made it impossible for the shareholders to realize BritNed under a regulated/ socialized regime such as the one proposed by the NRAs for the NEMO pilot, although this would have been TenneT Holding's preference at the time of the investment decision of the BritNed interconnector, moreover whilst at the last step of the regulatory approval process a cap on BritNed's returns was applied.

In this consultation Ofgem is using project NEMO as a pilot project for a new cap and floor regime for regulation of interconnector investment and will be evaluating the options of opening the regulated approach to future interconnector investments to develop a regulated regime that will co-exist alongside the merchant-exempt route. Ofgem envisages that once the cap and floor regime is finalized, they would use a similar approach for new interconnector investment projects in GB whilst ensuring that the arrangements are non-discriminatory between projects. This change in approach strongly relates to the outcomes of the 2010 Electricity Interconnector Policy Consultation that proved most developers feel the merchant option is no longer tenable when combined with the exemption process and that the merchant-exempt regime with a revenue cap is generally seen as a barrier to investment. Ofgem also does not preclude to evolve towards a fully regulated approach as the extent of interconnection increases between GB and other markets in the future.

TenneT Holding believes that in order to create a level playing field also existing projects should be incorporated in the evaluation for introducing a new regulated approach and that existing projects should not be precluded from moving to a regulated approach with caps and floors. Otherwise the introduction of a new regulated regime only lowers the barrier for new projects whilst increasing the downside risk for existing projects, such as BritNed, as through more cross border capacity between regions for existing

interconnectors the market price difference risk increases or the revenue opportunity decreases and a regulated regime allows new developers the opportunity to offer capacity under the target models for capacity, with for example higher levels of firmness, whilst being protected by a floor.

The objective should be to create a regime that is non-discriminatory between existing and future projects as also highlighted by the NRAs in chapter 3 of the consultation.

Conclusion

We believe that the regime proposed is a solution for the regulation of subsea interconnectors. However the regime can only be introduced if it provides a level playing field for both existing and new projects and both existing and new developers should therefore have the opportunity to opt into the new regime. BritNed's current risk-reward profile under the merchant-exempt regime is out of balance as the risk sharing between developers and consumers is very asymmetric and if new projects can opt for a regulated regime this would provide new developers with an unfair competitive advantage.

The cap and floor under the new regime should be set such that it reflects the proper risk sharing between developers and consumers. The market's valuation can be one means for setting the cap and floor, but can be too restrictive if it is defined as the income received by the interconnector owner as optimizing the interconnector revenues is not the ultimate goal of increasing interconnection; the ultimate goal should be to maximize the total net welfare to European consumers by bringing (socio-) economic and/or competition benefits and by improving security of supply and the integration of renewables. The regulatory regime should therefore be adaptable for the effects of increased market integration to establish the creation of one single energy market and ultimately a single price as well as for investments in interconnector capacity based on other drivers than market valuation such as the possible integration of renewable energy. We therefore support Ofgem's notion that as the extent of interconnection increases between GB and other markets, prices may converge and it may be appropriate to evolve towards a fully regulated approach, under which the cap and floor may converge on regulated returns in the future.

We welcome this consultation on the regulated regime for interconnector investment as a first step and would like to discuss in more detail with you how we can develop it into a regime that provides a level playing field between existing and new projects.

Yours sincerely,
TenneT Holding B.V.



J.M. Kroon
Chief Executive Officer