



Emmanouela Angelidaki and Phil Cope
European Electricity Transmission
Ofgem
Ofgem
9 Millbank
SW1P3GE

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Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We are supportive of the development of interconnection if the investment is economic in its own right, based on market price differentials. We are, however, concerned at the potential of the cap-and-floor regime to be distortive. The benefits that can potentially be identified for interconnectors are not unique; demand side response (DSR), peaking generation and storage, are all alternative, and potentially more reliable, balancing options. With GB consumers underwriting some of the project risk, the project evaluation process must therefore include an impact assessment that includes other technologies and/or balancing options.

The fact that interconnectors can potentially substitute for peaking generation and other technologies means that, while we appreciate that some of the contents of the discussions between the developer and National Regulatory Authorities (NRAs) may be commercial and confidential in nature, the underlying models used to assess the commercial viability, and the results of the business case must be revealed and open to scrutiny as a part of the public consultation. The extent to which new interconnector investments could distort the market, if the investment decision is not market-based, needs to be able to be understood by stakeholders. If the cost of a regulated return is being smeared across all consumers, we need to understand whether the market signals to invest in competing technologies are being dulled or lost.

The December 2011 preliminary conclusion letter outlined Ofgem's intention to develop further its enduring regulated regime and proposed process for evaluation of proposals. The former is addressed in this consultation but the latter appears to have been omitted. For the enduring regulated regime, we strongly believe that the evaluation process must be a critical part of the overall process and conducted in an open and transparent manner.

Finally as a supplier, we will be a conduit in collecting payment (via TNUoS) from consumers if the congestion revenues are below the floor. Ofgem will be familiar with the particular challenge faced by suppliers in terms of transparency and predictability of use of system charges. If customers are on fixed term retail contracts, then suppliers have to

EDF Energy
40 Grosvenor Place, Victoria
London SW1X 7EN
Tel +44 (0) 20 7752 2200

edfenergy.com
*EDF Energy plc.
Registered in England and Wales.
Registered No. 2366852.
Registered office: 40 Grosvenor Place,
Victoria, London SW1X 7EN*

cover this financial risk of forecasting, usually by charging an additional premium. Therefore, to mitigate additional cost impact to consumers, we would welcome visibility of future forecasts (at least 15 months in advance); any increase / decrease in TNUoS should distinguish the charge which results directly from the investment in new interconnector capacity.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 01452 658415, or me.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Angela Pearce'.

Angela Pearce
Corporate Policy and Regulation Director

Attachment

Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO

EDF Energy's response to your questions

CHAPTER: Two

Q1: Do you agree with our proposed regime design outlined in this chapter and Appendices 1 and 2? Is the design consistent with the high level principles established for the cap and floor regime in December 2011?

It is difficult to determine whether the proposed regime design is consistent with the high level principles¹ because the consultation appears to start from the premise that a business case for NEMO has already been demonstrated. We understand that as part of the business case, the developers would have had to provide detailed information to both NRAs to demonstrate the benefits of a new electricity interconnection between GB and Belgium. While we appreciate that aspects of the business case may be commercial and/or confidential, disclosure of some evidence is required to understand the welfare and competition effects of the proposed interconnector.

Provided that the business case for project NEMO has been demonstrated, the proposed regime appears reasonable. Comments on the consistency with the high level principles are provided below.

Principle 1: Unlike the merchant model, where the developers face the full upside and downside risk of their investment, consumers are effectively underwriting the downside risk under the proposed regime. A move to a regulated approach requires a transparent approach to project appraisal. Although Ofgem's December 2011 preliminary conclusions letter mentioned its intention to develop further its proposed process for evaluation of proposals which could be applied to projects beyond NEMO, nothing appears to have been published during the

¹ The high level principles established for the cap and floor regime are:

1. The regulatory framework will take into account the commercial viability of a project as well as considering the wider benefits efficient levels of interconnection can offer to consumers for example: security of supply, integration of renewable energy sources, competition and market integration across Europe
2. Consumers should be protected from the cost implications of excessive returns or market power that might accrue to interconnector owners,
3. Developers should be able to earn returns that are commensurate with the levels of risk they are exposed to under the regulatory framework,
4. Regulatory treatment of developers should be coordinated between National Regulatory Authorities (NRAs) at either end of the shared asset and
5. (For GB and new interconnector developments) Regulatory treatment should allow third party developers and should be impartial and unbiased between Transmission System Operators (TSOs) and non-TSO developers, existing and future developers

interim period. We would welcome more visibility of this process and the market modelling to support the assessment.

We suggest an assessment process similar to the Strategic Wider Works as illustrated below. Under step (4), instead of the TO allowance being provided, the provisional decision on cap and floor levels based on opex and capex forecasts can be provided. Step (5) could be the equivalent of the construction and post construction phase where the NRAs receive all bids and justifications for preferred bids and conduct ex-post review of actual capex and re-forecast of opex. Final cap and floor levels could be fixed at this stage. Under step (6), the revenues could be assessed against cap and floor every five years.

1	Eligibility Assessment	Ofgem determines the eligibility for assessment under the Strategic Wider Works assessment.
2	Needs Case Assessment	Determine needs case for the project, including the scope of proposed works and timing. This is based upon SQSS, cost benefit analysis, user commitment, etc. A consultation may also be necessary.
3	Project Assessment	Proposals are assessed against technical readiness and cost effectiveness, including that any outstanding pre-con work is on track according to proposed project timelines. At this point, Ofgem would issue its initial findings and issues under consideration for industry consultation- this includes TO funding allowances and outputs, and criteria for any future adjustments to costs or outputs.
4	Ofgem decision	TO allowance is provided for efficient costs of output.
5	Construction	Ofgem monitors progress towards outputs, and expenditure against profiled allowances.
6	Post construction	Assessment of performance in delivery of outputs.

Principle 2: Without any visibility of the business case, it is difficult to determine whether the design of the proposed regime is consistent with this principle.

Under the proposed regime, firmness is treated as a market related cost and netted off from gross congestion revenues. Net revenues are then assessed against the cap and floor values to determine if either has been breached. We understand there may be pass-through costs which might be treated in a similar way i.e. netted off from gross congestion revenues. If so, these pass-through costs should be identified in advance so that any assessment of excessive returns is transparent. This would align with the GB onshore and offshore regime whereby the pass-through costs have been defined².

Principle 3: Without any visibility of the business case, it is difficult to determine whether the design of the proposed regime is consistent with this principle. However, since our internal analysis suggests that the project should be commercially viable without consumer support, we suspect the proposed regime design will meet this principle.

² Licence fees and business rates are pass through costs for National Grid Electricity Transmission (NGET), SHE Transmission and Scottish Power. NGET have further pass through costs: Inter-TSO scheme, temporary physical disconnection and the termination of bilateral agreements.

Principle 4: This principle is met since the design of the high-level principles and the consultation has been co-ordinated by Ofgem and CREG.

Principle 5: This principle appears to be met.

Q2: Do you consider that provision for a financeability test within period outlined in this chapter and in Appendix 2 is needed with five year assessment periods? If so, how should the trigger point for financeability constraints be set?

No. While we appreciate that developers have no guaranteed revenue during the assessment period and developers need to be able to finance themselves in the intervening period, given that the consultation is starting from the premise that there is a business case for the interconnector, we are not persuaded that a provision for a financeability test within period is needed.

Q3: Do you consider the proposed arrangements (for market related costs and the availability incentive) incentivise high link availability?

Yes. If firmness is treated as a market related cost and netted off from gross congestion revenues, the exposure should incentivise the developer to maximise interconnector availability. Similarly, by making the floor payment conditional on availability being at or above a pre-defined minimum threshold, developers are incentivised to ensure high link availability.

Q4: Do you believe that there are opportunities for gaming by developers with our proposed regime design?

No.

Q5: Are there aspects of the proposed regime design for NEMO that should be reviewed for future projects, e.g. changes in capex treatment as more of these projects are built?

Yes. We agree with Ofgem that as more projects are built using the same technology as NEMO, more robust estimate of the costs of building an interconnector may be attainable and an ex-ante incentive-based treatment of capex may be possible for future projects.

CHAPTER: Three

Q1: Do you agree with our proposed approach on the key methodology considerations? Is our approach consistent with the high level principles established for the cap and floor regime in December 2011?

Assuming that a business case for NEMO has been demonstrated, we agree with the key methodology considerations outlined in the consultation. In particular, we agree that:

- separate WACC calculations at the cap and floor is needed;
- a mechanistic approach should provide investor clarity and certainty;
- the cost of capital parameters should be locked-down at financial close; and
- blended cost of capital calculations should be applied on a 50:50 basis between the two jurisdictions.

Q2: Do you agree with our approach of using the cost of debt and equity to set returns at the floor and cap respectively, while acknowledging that that the appropriate level of the cap and floor returns are interrelated?

Yes, assuming that a business case for NEMO has been demonstrated.

Q3: Do you agree with our proposed approach to setting interest during construction (IDC) outlined in this chapter and Appendix 4? Are there any other relevant risks/factors that we should be aware of when developing an IDC methodology?

Based on the information provided, the proposal appears sensible.

The IDC methodology should ensure that it produces a fair and balanced outcome for investors and customers.

CHAPTER: Four

Q1: Is our analysis on Return on Regulated Equity (RoRE) considerations consistent with the high level regime principles?

Yes, assuming that a business case for NEMO has been demonstrated.

Q2: Do you think that our proposed RoRE range is sufficiently wide enough to retain market incentives within a regulatory framework?

Yes.

CHAPTER: Five

Q1: Do you agree with the proposed high level principles for considering the connection process in the regulatory decisions on electricity interconnector investment? Are there any other areas that need to be considered in the principles?

Yes. The absence of financial signals directing the location of interconnector connections within GB could lead to inefficient choices of connection location and subsequent operation which exacerbates rather than alleviates congestion in the GB market price area. Consequently, it is important to ensure that there are effective arrangements for coordinating existing TSO activities with those of separate developers of new interconnectors. Therefore, we agree with the proposed high level principles for considering the connection process in the regulatory decisions.

Q2: Do you have any views on the regulatory decision making process for project NEMO and on any other areas of consideration for the cap and floor regime beyond NEMO?

Yes. As mentioned above, we believe more transparency is needed in the evaluation of projects given its potential distortive effects on the market and because consumers are underwriting the majority of the investment. Project evaluation should form part of the consultation for any future projects which wants to go down the regulated route. When assessing future projects Ofgem should consider whether the project business case is sufficiently well justified. This method would ensure that the regulatory decision making process is aligned with the existing methods utilised by Ofgem in the GB onshore.

**EDF Energy
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