FAB Link Limited

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Messrs Emmanouela Angelidaki and Phil Cope
European Electricity Transmission
Office of Gas and Electricity Markets
9 Millbank
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2nd May 2013

Dear Emmanouela, Phil,

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

FAB Link Limited is a joint venture company owned by Alderney Renewable Energy Limited and Transmission Investment LLP. As you are aware FAB Link Limited has been developing a new interconnector between France, Alderney and Britain since 2010. Since 2011 we have studying the project in partnership with RTE. We have engaged with Ofgem on several issues relating to this over the past 3 years including the development of a cap & floor regime and most recently met with you on 15th April. We found this a helpful and informative meeting to understand further Ofgem's thinking behind the proposed regime.

In general we are pleased with the proposed methodology for a cap & floor regime even though we acknowledge that at this stage it is NEMO specific. We have set out our high level comments in this covering letter and respond to the specific consultation questions in the attached Annex.

We consider that in developing the proposed regime, on most issues Ofgem has correctly balanced the need to encourage viable projects whilst leaving projects incentivised to manage those risks they can. We would like to see further development of and more detail on the financeability test as we see this as potentially being important for FAB Link. We set out further details on how we would like to see this develop in the attached Annex.

We recognise that the cap & floor regime in the UK will need to interface with a more traditional transmission regulatory regime in France. Whilst in general we do not foresee problems in this, we note that FAB Link is being developed by two parties one of whom is not and will not be regulated by Ofgem. We and our project partners would like to understand the extent to which Ofgem would, in a project like FAB Link, need to assess costs incurred by the non-GB regulated party to implement a cap & floor regime on the GB side.

We are very concerned with the proposed delay in dealing with the FAB Link application for cap & floor treatment (submitted in September 2012) until after the cap & floor decision on NEMO (scheduled for the end of 2013). We would urge Ofgem to reconsider this in light of FAB Link's provisional status as a Project of Common Interest.

Yours sincerely

Chris Veal
Director

Annex: Responses to specific consultation questions

Chapter Two

Question 1: 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?

We are broadly in agreement with the proposed regime, and believe it provides a workable framework for achieving FABLINK's financing strategy, even though this is somewhat different to that of the NEMO sponsors. In certain areas, however, we do not believe the proposals fully achieve Ofgem's objective that the regime be "finance solution invariant." In our view, annual assessment periods leading to cash flows to or from NETSO in the following year (as for OFTOs) would bring the regime most fully in line with this objective. Cumulative annual assessment over a five-year period would also be an improvement on a single assessment after five years.

Question 2: 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?

We do consider that a financeability test is needed with a five-year assessment period, for the reasons and to serve the purpose laid out in Appendix 2 to the consultation. To serve this purpose effectively, we believe the test should be triggered at a level not lower than the floor. We would recommend that the test be implemented in a way that leaves no more discretion than absolutely necessary in the hands of the regulator.

Question 3: Do you consider the proposed arrangements (for market related costs and the availability incentive) incentivise high link availability?

We consider these proposed arrangements to be appropriate and effective for incentivizing high link availability.

Question 4: Do you believe that there are opportunities for gaming by developers with our proposed regime design?

We do not see any such opportunities in the proposals.

Question 5: 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?

We understand that even with an ex-post capex review the developer is incentivized to minimize capex (since the ex-post assessment will only affect revenues at the floor or cap). However, we still consider that Ofgem should review the equipment supply and construction contracts at Financial Close and carry out an ex-ante capex assessment at that point, based on the substantial amount of benchmarking data that Ofgem has at its disposal from its review of offshore transmission assets. This would reduce regulatory risk for interconnector developers at Financial Close. Following Financial Close, capex risk is best managed by the interconnector developer either directly or through its choice of construction contracting strategy.

Chapter Three

Question 1: 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?

We agree with the proposal to use separate WACC calculations at the cap and the floor based on RAV, the use of a mechanistic rather than a deterministic approach, the lock down on Cost of Capital at financial close, the use of CAPM and 50% notional gearing to set the operational Cost of Capital, the calculation of the IDC rate, the treatment of refinancing gain, and the provision of an allowance in RAV for debt and equity transaction costs.

We would suggest, however, that there should be an appropriate allowance for the particular risks associated with development costs, perhaps within the framework of the IDC allowance.

Question 2: 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 the appropriate level of the cap and floor returns are interrelated?

Yes.

Question 3: 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?

Yes, however, please note our suggestion for incorporating an appropriate allowance for development costs within the methodology for calculating IDC.

Chapter Four

Question 1: Is our analysis on Return on Regulated Equity (RoRE) considerations consistent with the high level regime principles?

We suggest that the Return of Regulated Equity at the floor should be moderately higher than the cost of debt, provided appropriate availability requirements are met. History has demonstrated that it has been very difficult to attract investment into fully merchant interconnector projects. We consider that if government policy to significantly increase electricity interconnection between Britain and the rest of Europe is to be achieved then the regulatory regime will need to attract a broad and deep pool of investors, many of whom will have competing investment opportunities in for example offshore wind and transmission projects. The pool of investors for interconnectors would be expanded if the floor was set above the cost of debt, even though we recognise that the corollary of this will be to have a lower cap.

This will of course be essential once the level of interconnection is such that interconnectors will not be built by entrepreneurial developers based on expected congestion rents alone, a level that academic theory indicates would be below the economically efficient level of interconnection[1].

[1] See "Merchant Transmission Investment", Paul L. Joskow, Jean Tirole, Working Paper 9534, http://www.nber.org/papers/w9534, National Bureau of Economic Research

Question 2: Do you think that our proposed RoRE range is sufficiently wide enough to retain market incentives within a regulatory framework?

See previous comment.

Chapter Five

Question 1: 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?

We have followed the process set out in the consultation document in respect of FAB and have adopted a collaborative approach with NETSO including a joint analysis of the interconnector and onshore grid system costs for the connection of FAB.

We note that whilst increased interconnector costs as a result of this collaborative exercise may be reflected in the RAB, and therefore the cap and the floor revenue values, these costs will not be reflected in the expected income and therefore will depress the expected project returns compared to a connection location with lower interconnector costs (e.g. one nearer the coast). We do not consider that this gives the correct incentives to interconnector developers, who are being asked to bear costs without benefits, and consider that if a holistic collaborative approach is used such projects should receive an additional regulated income stream reflecting the onshore transmission system costs avoided. This income stream could also be reflected in the cap and the floor revenue values and would lead to interconnector developers having the correct siting incentives.

Also having been through this process, we do not believe the connection application process is the right one for regulated interconnectors. It is unpredictable at best and even the close collaboration we have tried to employ does not necessarily result in a solution that is optimum for the interconnector and onshore network combined. It should certainly not be a model for an enduring regime under ITPR where some degree of centralised planning of interconnectors should be undertaken which is not subject to the vagaries of the connection application process. This is particularly so when an affiliate of NETSO is developing competing projects!

Question 2: 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?

Ofgem has been considering options for the regulation of interconnector projects since before the publication of the consultation document in January 2010. The FAB Link project promoters have been engaged with Ofgem on possible regulatory solutions for FAB Link since 2010. Moreover we have impressed on Ofgem the need for early regulatory certainty in respect of cap & floor treatment for FAB Link, including submitting an application for Cap & Floor treatment, since the middle of 2012. We are therefore very concerned that Ofgem has only consulted on the treatment to NEMO and will not open up the process for other projects until the end of 2013 when it has concluded the regime design and taken a decision on the Cap & Floor levels for NEMO. We would urge Ofgem to open up the process immediately for the consideration of other well advanced projects that had for example met certain hurdle criteria (such as provisional PCI status or signed connection agreements).
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