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Dear Emmanouela

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

National Grid Electricity Transmission (NGET) welcomes the opportunity comment on Ofgem's consultation on the Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO. This response is on behalf of National Grid Electricity Transmission plc in its capacity both as the National Electricity Transmission System Operator (NETSO) for GB and the Transmission Owner (TO) for England and Wales. This response is not confidential.

The proposed regime raises several issues from NGET's perspective. We agree that it would be beneficial to establish clear principles regarding the interconnector application / offer process to be used in the interim until, following the conclusion of the ITPR project, an enduring framework is established which reflects the need to treat interconnectors as transmission and not generation. We plan to develop proposals in regard to this, taking account of stakeholder views, and will consult on them as suggested in the consultation document.

The cap and floor regime will need a framework to facilitate the exchange of funds between NGET and NEMO (or any other interconnectors utilising this regime) to reflect the interconnector's performance against their cap and floor. The process for this should mirror the approach used for other network owners such as the Scottish TOs and OFTOs and we do not see this as particularly complex or controversial. While the need to use such a mechanism is many years away, early clarity on the process can only be helpful for developers.

We also believe that it is essential to have clarity regarding the basis on which the "economic and efficient" test is applied to interconnector projects and the associated onshore reinforcements. We believe that the EU Third Package may require a wider approach to this test than the GB focused approach described in the consultation document. TOs responsible for onshore reinforcements required for new interconnectors (as well as the interconnector developers themselves) need to understand the approach Ofgem will take to this issue before they commit to significant investments involved.

We have set out our thoughts on these areas in more detail in the attachment to this letter. If you would like to discuss any of the points we have raised or have any questions regarding them then in the first instance please contact Andy Balkwill (andy.balkwill@uk.ngrid.com or 01926 65 59 88)

Yours sincerely

[by e-mail]

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Consultation Questions

Most of the questions in Ofgem's consultation were directed at interconnector developers and so NGET has no comment on them. Chapter 5, however, relates directly to NGET's role in managing connection applications from interconnector developers and in coordinating the development of the interconnector with the relevant onshore network reinforcements. We have set out our response to Chapter 5 Question 1 below.

Chapter 5 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?*

While we agree with the principles set out in Chapter 5 in general we consider there are areas that require important clarifications.

Basis of the "economic and efficient" assessment

In the bullet points under Chapter 5 paragraph 5.5 of the consultation Ofgem refer to the need for NGET and the developer to cooperate and coordinate to deliver an economic and efficient connection for the project and the GB system as a whole at least cost to GB consumers. Greater integration with Europe raises fundamental questions regarding the obligations placed on us by the Electricity Act – namely "...to develop and maintain an efficient, co-ordinated and economical system of electricity transmission..." (Electricity Act section 9(2)). European law takes precedence to UK law and so we need to be conscious of the way our obligations under the Electricity Act and our licence need to be interpreted in order to be consistent with the policy enshrined in Electricity Directive and the rules set out in the Electricity Regulation¹ including the requirement to coordinate and cooperate with other TSOs in relation (amongst other things) to cross border activities.

Development of interconnectors normally involves multiple design options in terms of the locations of the onshore terminals, the landing points at each end, the cable routes between those terminals, and the onshore network reinforcements required. Each option has different cost and risk implications for the developer and for the TOs at each end. It is unlikely that the lowest cost option for each party individually will be consistent with the lowest cost option overall. For example, a longer submarine cable route (increased cost) may enable a different connection point resulting in a significant saving in onshore reinforcement costs. We consider that it may be appropriate to interpret the objectives of the Third Package as supporting infrastructure being developed at the lowest overall cost (i.e. considering both the transmission systems being interconnected as well as the interconnector itself). If this approach is followed then it is likely that the lowest overall cost solution may involve one or more parties needing to undertake a design that is not the lowest cost for them, but which facilitates the lowest cost overall solution². As such, and given the requirement for national law so far as is possible to be interpreted so as to be consistent with EU law, we consider that compliance with the obligations to be "...economic, efficient and coordinated..." probably need to be considered taking into account a wider European view.

We therefore believe that focusing on the most economic and efficient GB solution may be overly narrow and risk increasing costs to consumers overall in the longer term. In our view there is a case for the project to be assessed as a whole and this implies that the "economic and efficient" obligation placed on NGET by the Electricity Act would need to be interpreted in a different way in future. TSOs (and developers) would need to demonstrate that the overall solution is the most economic and efficient and would therefore deliver the highest social welfare for consumer in the EU as a whole. However, we recognise that the development of a single energy market has many facets and views will often differ over who benefits from a particular development and therefore whether it is in consumers interests or not. This is reflected for example in the range of responses in relation to CMP 201.

¹ Directive 2009/72/EC and Regulation 714/2009

² The ITC scheme provides a mechanism for TSOs to compensate / be compensated for the costs of hosting flows on their systems that derive from transmission systems in other member states. This may provide scope for compensating a TSO in one member state that bears a disproportionately high reinforcement cost to accommodate a lowest overall cost interconnector development.

The third bullet point of paragraph 5.5 Ofgem states that “...only costs incurred to realise an economic and efficient connection location...” would be considered [for remuneration] and that additional costs “...e.g. inefficient onshore reinforcement or constraint costs...” may “...be disallowed from the RAV...”. It will therefore be essential for developers, onshore TOs and the NETSO to be absolutely clear at the outset on how their design proposals will be treated and the benchmark against which their investments will be assessed. We would therefore welcome an industry debate on this issue with a view to obtaining the necessary clarity. The attitude of the regulatory authorities at the both ends of any prospective interconnector will also be a relevant factor and so it will be helpful for Ofgem to consult with and agree a common regulatory approach with fellow regulators so that transmission owners and interconnector developers have the necessary clarity and certainty to enable efficient investment to take place.

Given the primacy of EU legislation in this area, it would, in the longer term, be helpful to remove the scope for conflict or confusion between EU and national legislation by clarifying the obligations in the Electricity Act. In the interim, a clear statement from Ofgem (and other relevant regulators) regarding the interpretation that should be adopted should be sufficient to allow investment to proceed.

Coordination and cooperation

Paragraph 5.2 includes the statement:

“...implementation of the Third Package clarifies that interconnectors should be treated as transmission, rather than generation or demand. As a result, interconnector owners have the responsibilities of TSOs and have a duty to consider an economic efficient and coordinated solution for the project and for the wider GB transmission grid...”

This obligation only applies to an interconnector developer where they already hold an Interconnector Licence. Where no licence is present there is nothing to require interconnector developers to act in a cooperative or coordinated manner. In the event a developer was to seek a cap and floor regime Ofgem could take account of any inefficiency in their project by adjusting the cap and floor. If the developer seeks an exemption rather than the cap and floor regime then it is not clear what powers are available to Ofgem to expose the developer to the consequences of inefficient and uncoordinated decisions. NGET has sought to include appropriate contractual terms in its connection offers to interconnector developers addressing the obligations that apply to TSOs – however these are not backed by a licence and we feel that consideration should be given to the requirement for applicants to obtain a “light licence” to provide appropriate clarity over this issue.

Enduring Contractual Framework for cap and collar regulated interconnectors

We agree that following the implementation of the EU Third Package it is now clear that interconnectors are to be treated as transmission rather than pseudo generation / demand. Currently the contractual framework applying to all interconnectors connected to the GB transmission system is the Connection and Use of System Code (CUSC). The CUSC (and Grid Code) can be characterised as the contractual framework between the NETSO and those parties connected to or using the GB transmission system. CUSC treats an interconnector as a generator / demand. Grid Code technical requirements are also applied to interconnectors on the basis that they are pseudo generators / demand.

The evolution of BETTA led to the need to establish the System Operator – Transmission Owner Code (the STC) as a contractual framework to manage the relationship between the NETSO and the Scottish Transmission Owners. The STC now additionally encompasses the Offshore Transmission Owners (OFTOs). The STC provides the framework for managing the obligations between the NETSO and TOs including the charging arrangements under which the NETSO pays TOs for the transmission services that they provide. The STC also provides the framework for managing the relationships between the TOs (e.g. where their assets are connected together) and addresses issues such as joint system planning and development in accordance with the obligations imposed by the Electricity Act and the TOs’ respective licenses. In comparison to the CUSC, the STC can be characterised as the framework between the NETSO and network owners.

There is a case for developing the STC so that it can provide a framework for managing the relationship between Interconnectors Owners, the NETSO, and affected TOs. However, such a process will represent a significant piece of work, may need to be enforced through a “light licence” regime, and may not be delivered quickly enough to be a suitable route for the NEMO project. Equally changes to the CUSC, or the development of an entirely new regulatory code, could deliver the necessary framework. Again, each represents a major piece of work. Furthermore, conclusion of Ofgem’s ITPR project (which is now not expected to conclude until spring 2014) may identify other hybrid interconnector / transmission infrastructure arrangements that need appropriate regulatory / contractual frameworks. Therefore, we consider it makes sense to wait until the ITPR project has concluded before embarking on a major piece of framework development. An additional benefit of waiting until the conclusion to ITPR will be that we will also have greater clarity regarding any requirements imposed by the European Network Codes currently being developed by ENTSO-E and ACER, or issues arising out of the EMR regime.

Interim arrangements for interconnector applications

We agree that it would be beneficial to establish clear principles regarding the interconnector application / offer process to be used in the interim (until an enduring framework is established which reflects the need to treat interconnectors as transmission and not generation). We broadly agree with the principles identified by Ofgem in Chapter 5 of the consultation. However we consider that further consideration is needed regarding the basis on which the “economic and efficient” test is applied – we have set out our thoughts on this issue above. We further note that some of the requirements identified in the principles will not benefit from backing by regulatory frameworks or by any licence.

As noted in the consultation, interconnectors are no longer subject to TNUoS charges and so face no locational signal in relation to the NETS. Once an Interconnector owner has received a licence from Ofgem then they are bound by the obligations in that licence which include those applicable to TSOs under the Third Package (see Article 12 in particular). These obligations include coordination and cooperation over the development of their network. However, interconnector developers are not required to obtain licences until the link has been constructed and so these obligations are not binding during the crucial development process. We welcome Ofgem’s suggestion that only costs that are economic and efficient should be considered in regulatory decisions for interconnector investment. However we note that this proposal only has “teeth” where the developer seeks to operate within the cap and floor regime (as opposed to the exempt regime).

We plan to develop interim proposals in regard to the connection application / offer process as well as any contractual changes that we consider may be needed for the cap and floor regime, taking account of stakeholder views, and will consult on them as suggested in the consultation document.

Revenue Transfers between the NETSO and Cap and Floor Regulated Interconnectors

The Cap and Floor regime will require a mechanism that provides for the NETSO to recover interconnector revenues that are in excess of the cap over the relevant (5 year) period, or to make payments to the interconnector owner where their revenues have been less than the applicable floor over the same period. There is currently no mechanism within CUSC or the standard CUSC bilateral agreements for this. However there is no reason why in principle appropriate bespoke terms could not be developed for inclusion in a bilateral agreement between the NETSO and an Interconnector Owner. Given that we would anticipate that these terms would be common to any interconnector operating under the cap and floor regime it would be appropriate to consult on the general form of the contract terms (though obviously not aspects of the contract that should remain confidential).

The need to use the new contractual process for transferring funds between the NETSO and Interconnector Owner is some years away³ before it is possible to determine what funds need to be transferred between the parties. As a result the current priority should be to establish clear principles so that investors are able to understand the implications of the processes and take account of them. We consider that the changes that are likely to be needed to NGET’s Transmission Licence should be

³ The TEC register shows NEMO due to commission in October 2018 and so the impact of the cap / collar would not bite until 5 years later – so around 2023.

straightforward and uncontroversial. They would be needed to provide for the ability to adjust Transmission Network Revenue to reflect any sums due from/to an Interconnector Owner as a result of the triggering of the cap/floor. The addition of a new term in Special Condition 3B: Calculation of Allowed Pass-Through Items should provide an appropriate route to do this. The new term (with an appropriate definition in Special Condition 1A) should mirror the existing terms “TSP_t”, “TSH_t”, and “TOFTO_t” which are used for adjusting NGET’s allowed revenue to take account of Scottish TO and OFTO charges.

TNUoS Charging Methodology Changes

Changes to National Grid’s TNUoS Charging Methodology may be needed to set out how the interconnector revenue excess/ shortfall should feed into the calculation of TNUoS charges. The additional source of revenue variation implied by the cap and floor regime may have implications for TNUoS volatility and our ability to forecast TNUoS charges given that every 5 years the interconnector revenues will be assessed against their cap /floor and an adjustment to TNUoS may be needed to reflect the payments from / to the interconnector owner. NGET presently provides a five year forecast of TNUoS to customer as well as quarterly updates of the year ahead TNUoS charges. Once we have a better understanding of the processes involved in identifying the consequences of the cap/floor process then we will be able to clarify the potential impact on our TNUoS forecasts. In terms of the timing of any assessment by Ofgem of interconnector revenues and the triggering of the cap/floor payments then from NGET’s perspective a decision by early December of the relevant year would facilitate a consequential change to be made to TNUoS charges commencing in the following April.

Financial Security

Payment of sums by the NETSO to an interconnector owner (or any other GB transmission owner) are protected by the regulatory framework applying to NGET (including the Special Administration arrangements that are available in the extremely unlikely event that NGET suffered financial difficulties). However, in the event that an interconnector had earned revenues higher than the cap in a previous 5 year period such that it was due to make payments to the NETSO in the subsequent 5 year period, then there is a question regarding the level of protection that the NETSO and the consumer should have in the event that the interconnector owner suffered financial distress during that subsequent 5 year period (e.g. as a result of a long term fault) and was unable to continue to make the payments due to the NETSO.

Other Points

In paragraph 2.2 Ofgem refers to the cap and floor being set on the basis of congestion revenues. It is not clear whether this is intended to include other sources of revenue – e.g. in respect of balancing or ancillary services – which may be delivered irrespective of whether the interconnector is congested or congestion rents being earned. From NGET’s perspective, the availability of response and reserve services over interconnectors may become increasingly important as we are required to manage increasing volumes of intermittent generation. As a result, we consider that it is important that interconnector developers have an incentive to design their equipment so it can provide such services and to make those services available.

Prohibition on TSO Developing Interconnectors

In paragraph 1.12 Ofgem states that the regime has been designed “...with the intent to be open to third party investors and ensure an impartial and unbiased treatment between TSO and non-TSO developers and between existing and future developers...”. Clearly it fails to do this because the Electricity Act 1989 Section 6 (2A) precludes the holder of a transmission licence from also holding an interconnector licence and so existing TSOs are denied the opportunity of competing with non-TSO developers.

With a regulated interconnector regime being established, we do not believe there is any reason to maintain the current prohibition. We recognise that a primary legislation change would be required to remove the current prohibition but would encourage Ofgem and DECC to consider this next time

changes are envisaged to energy legislation. It is worth noting that EU legislation only requires only that TSOs do not own **exempted** interconnectors. UK legislation goes further than the requirements of EU legislation by precluding Transmission licensees from participating in **any** form of interconnector. The reasons for extending the scope of this prohibition beyond that required by EU legislation have never been clearly set out. The prohibition was introduced at a time when Ofgem's policy was that interconnectors could only be developed under an exempt framework; there was no concept of a "regulated interconnector" with its revenues underwritten by consumers. Clearly this position is now changing and the underlying statutory regime need to be reappraised in order to facilitate this development in policy.

Indeed, since Ofgem's policy has now changed for the reasons set out in its consultation and regulated interconnectors are now clearly contemplated, it is now unclear what purpose the prohibition on transmission licensees developing interconnectors serves. Why should an OFTO or an onshore TO not engage in the development of an interconnector under a regulated regime where this can be shown to be in the interests of consumers? By continuing to prevent transmission licensees from participating in this space, there is a danger that consumers lose out because a potentially good source of development ideas, expertise, and financial resources is excluded. We recognise that there may be concerns over conflicts of interest if NGET were to be directly involved in interconnector development because of its role as NETSO – however a Licence based prohibition could readily address this rather than the current prohibition on all transmission licence holders provided in the Electricity Act Section 6 (2A).