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NorthConnect response to Ofgem consultation **Cap and Floor regime for Regulated Electricity Interconnector Investment for application to Project NEMO**

The NorthConnect project is a joint venture planning to build and operate an HVDC interconnector between Norway and the UK. The company is owned by: Vattenfall (SWE), Agder Energi (N), Lyse (N) and E-CO (N). They are reputable energy market players with the necessary skills and capacity for execution of such large infrastructure projects.

NorthConnect considered the proposed cap and floor regime for the project Nemo as well-reasoned with adequate analysis. The proposed regime represents a pragmatic compromise between a range of competing interests and the overall impression is that proposal reflects the different stakeholder's interest in a balanced way.

The proposed regime facilitates for a project developer driven approach, with focus on the merits of the actual interconnector project, rather than organisational and owner issues as 3rd Party project versus TSO project. NorthConnect fully support this view. As long as the interconnector capacity is market coupled with full third party access, the difference between TSO and non-TSO projects is primarily financing. Consequently, NorthConnect consider the main socioeconomic merits of the different type of projects to be very similar. If the Cap and floor regime is adopted by the EU as the model for 3rd Party interconnectors, it could solve the following key issues related to the current regulatory framework for development of cross border capacities in the EU/EEA region:

- Getting acceptance in Norway, Sweden and the EU that market coupled 3rd party Interconnector projects are a relevant supplement and necessary corrective to TSO projects
- Attracting new types of investors due to reduced risk (life insurance companies) as well as new types of owners with adequate skills and execution capacity for development and construction of interconnectors
- Protect investors against the implications of TSOs moving internal bottlenecks to the border.

NorthConnect is of the opinion that the project developer approach, driven by identifying and developing interconnector projects where socioeconomic potential is unexploited, should be utilised for the betterment of society. Consequently, NorthConnect, encourage Ofgem to make efforts to

achieve a European wide acceptance and recognition of the potential socioeconomic contribution from 3rd party interconnectors as a supplement to traditional TSO projects.

The EU Commission has, by concrete decisions related to merchant interconnectors, shown that they are hesitant towards merchant investments. Consequently, the proposed model should increase the speed of necessary investments in Europe. This model may also solve the issue of the merchant approach not being compatible with other European Member States, and who might tend to underinvest from a welfare perspective. This is an issue that should be addressed further in the future work. The values of an interconnector and associated trade with electricity are more than just congestion rents. Thus the congestion rents may only at best serve as proxy for the socioeconomic values created.

In addition, the proposal discusses the concern related to how the move from a merchant approach to a regulated approach requires more assessments on the optimum amount of investments in Interconnectors. However, there are no current signs of over-investment in transmission in the UK or rest of Europe. In fact, due to the comprehensive changes in the power systems driven by EU 2020 targets, investment is failing to keep pace with strategic need, evidenced by the fact that one in three TYNDP projects are now behind schedule or cancelled. Given the rather large changes faced by the UK electricity system, it must be highlighted that the levelised cost of capital of a transmission interconnection is far below any alternatives (e.g. gas or nuclear generation). Thus the value in applying transmission as part of the solution to “keeping the lights on”, seems heavily underestimated in the reasoning concerning the protection of consumer’s interest. The possibility of transmission capacity providing services at a lower cost than competing generation should be acknowledged. This also applies in context of possible future capacity markets.

There are currently different processes under development on an European level, likely to have impact on interconnector revenues, such as Entso-E network codes on capacity allocation and management and forward capacity allocation. In future work Offgem should clarify what impacts a combination of different regulations would have on the Cap and Floor model.

Furthermore, NorthConnect supports the approach of project specific assessment of availability. However, there is a need for a distinct definition of target availability (the difference between technical and market availability needs to be addressed properly). In addition, it is crucial that the model for calculating target availability is consistent with the model to calculate actual availability, and that neither should include market-driven or external technical factors (e.g. restrictions on availability from capacity allocation, grid or connection issues, user codes, generation load factors or ramping requirements). This issue should be addressed in the future work.

Answers to questions

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

Answer: NorthConnect acknowledge the need to incentivise high link availability within the context of a cap and floor regime. NorthConnect agree that the availability incentive should apply to the cap only. Further, NorthConnect agrees that the target availability should be set on a project-by-project basis and based on continuously updated analysis/databases of the SKM model.

NorthConnect seek clarification that calculations of target availability and measured availability are based on the same methodology and factors.

NorthConnect are concerned about the implications for interconnector availability/firmness (especially for stand-alone asset and merchant interconnectors) arising from the current development of the Entso-E Network Codes on Capacity Allocation and Congestion Management. These models are likely to curtail interconnector capacity available for the market. It is vital that the evaluation of observed (actual) availability against the target is based on internal, interconnector-specific, technical factors only. Any curtailment of capacity arising from market design or other market related factors, or from external technical factors (e.g. grid or connection issues, user

codes, generation load factors or ramping requirements), on either side of the interconnector should not have consequences for the cap through availability incentives.

Please find answers to the rest of the questions in the attached Appendix.

Kristiansand, 2013.05.02

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Appendix – Questions and Answers

CHAPTER: Two – Regime design

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?

Answer: Yes

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?

Answer: Yes.

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

Answer: Answered above

CHAPTER: Three – Methodology for setting cap and floor returns

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?

Answer: Yes.

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 that the appropriate level of the cap and floor returns are interrelated?

Answer: Yes.

Question 3: Do you agree with our proposed approach to setting interest during construction (IDC) outlined in this chapter and Appendix 4?

Answer: Yes.

CHAPTER: Four – Implications of our proposed design and cap and floor return methodology

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

Answer: Yes.

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

Answer: Yes.

CHAPTER: Five – Interconnector investment regime: wider issues and next steps

Question 1: Do you agree with the proposed high level principles for considering the connection process in the regulatory decisions on electricity interconnector investment?

Answer: Yes.

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?

Answer: *NorthConnect support the Cap and Floor regime, and encourage OfGem to seek further cooperation with other European NRA's in the matter.*