

OFGEM Consultation Ref: 28/13
**Cap and Floor Regime for Regulated Electricity Interconnector
Investment for application to project NEMO**
RTE response

Réseau de Transport d'Electricité (RTE), the French Transmission System Operator, welcomes the opportunity to respond to the consultation on the *“Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO”*, launched by Ofgem and issued on 7th March 2013 on its website.

On 2nd Sept 2011, RTE responded to the Ofgem/CREG joint consultation issued on 28th June 2011 *“Cap and floor regime for regulation of project NEMO and future subsea interconnectors”* and gave its opinion on the principles of the proposed regulation.

As RTE noted in its answer to the 2011 consultation, security of supply and integration of renewable energy are among the key motivations for building new interconnectors. Moreover, RTE considers that the development of regulated interconnections must be coordinated within the global regulated electric system. RTE understands that the current “developer led” model has not fostered sufficient interconnection investments linking GB and its neighbours. The necessity to reinforce the links with the continent appears more and more necessary to comply with European objectives of security of supply, sustainability and market integration.

In parallel, in France a new incentive regime for future interconnectors has been developed by the regulator CRE, and is to be implemented as from 1st August 2013. It is of utmost importance that regulatory regimes from both sides of the border are compatible.

The current consultation exposes implementation details of the proposed regime for NEMO which does not affect RTE directly. RTE understands that such an approach would apply to future regulated interconnectors to be built between Great Britain and the continent. That's why RTE does not intend to answer every questions, but wishes to remind the general principles it considers important regarding interconnectors investments.

1. The legal framework of interconnectors

The consultation document states that *“the [cap and floor] 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.”*

RTE would like to recall that, except for very specific exceptions, the French legal framework “Code de l’Energie” currently does not provide the possibility for a third party to own and operate a transmission line on the French public territory.

This means that except in very specific cases, high voltage lines on the French territory, including French territorial waters and its Exclusive Economic Zone provided they are connected to the public onshore network, belong to the concession granted to RTE.

Accordingly, all such assets are to be regulated according to French regulation.

2. The regulation regimes of interconnectors

In its response to the 2011 Ofgem/CREG joint consultation, RTE explained the main elements of the French regulatory approach of interconnections.

RTE is about to enter a new regulation period from 1st August 2013 (known as “TURPE 4”) for a duration of approximately 4 years. The principles governing this new period are set in CRE’s decision dated 3 April 2013. The new regime provides that RTE will make an annual reporting of all RTE’s investments maintaining or increasing interconnection capacities, allowing to check that the amount of such investments is in line with auction revenues, thus complying with art. 16.6 of 714/2009 European regulation.

Moreover, with TURPE 4, CRE implements an incentive scheme intended to favour interconnection investments, which will apply to interconnection investments initiated during next regulatory period.

The construction of a regulated interconnector linking France and GB would be conducted by two parties: the GB developer and RTE, each one submitted to their respective national regime. Therefore, it is essential that both French and GB mechanisms are compatible to ensure a stable regulatory framework during construction and operation.

To identify potential similarities and differences, the French scheme is presented below and compared to RTE’s understanding of the cap and floor regime.

Regime	CRE (TURPE 4)	Ofgem (Cap and Floor)
Principles	<ul style="list-style-type: none"> • Stimulate the achievement of assets useful for the European system; • Encourage RTE to conduct investments in the best cost and time conditions; • Encourage RTE to efficiently operate the newly created interconnection asset, particularly in terms of trade flows provided by the asset. • Ensure that RTE can earn premiums that are commensurate with the value created for the community (European Socio-Economic Welfare) by allowing RTE to retain a portion of this value. 	<ul style="list-style-type: none"> • Protect GB consumers from the implications of excessive revenues for developers; • Overcome the challenges of the merchant approach, without the use of an exemption; • Ensure that developers can earn returns that are commensurate with the levels of risk they are exposed to under the regulatory framework.
WACC	<ul style="list-style-type: none"> • “Floor” = regulated WACC (7.25 % nominal pretax during the forthcoming TURPE4 period; may change, according to future “TURPE” regulated WACC). • Premiums: <ul style="list-style-type: none"> ○ Portion of the value created for the community (fixed premium based on forecasted commercial flows, electricity market prices and investment costs) ○ cost incentive (based on actual cost <i>versus</i> cost announced by RTE) ○ incentive based on commercial cross-border flows (actual <i>versus</i> expected; if appropriate, commercial flows could be considered between France and several countries). • “Cap”: the sum of premiums is 	<ul style="list-style-type: none"> • Floor = normative cost of debt (real vanilla) • Cap = based on the cost of equity of an electric generating plant (real vanilla) +/-availability incentive • Tax allocation (RAV increase) • Transaction cost allocation for debt and equity (RAV increase)

Regime	CRE (TURPE 4)	Ofgem (Cap and Floor)
	capped according to the interest of the interconnection for the community and the amount of the investment.	
Gearing	Normative leverage of 60 %: the regulated WACC corresponds to a nominal pretax ROE of 11.2 % during TURPE 4.	Leverage varying from 50 % at the beginning to 0 % when debt is paid back. Therefore the ROE can be higher than the cap.
Duration	<ul style="list-style-type: none"> • Regulated WACC : accounting lifetime • Premiums : 10 years maximum 	20 or 25 years
Assessment period	<ul style="list-style-type: none"> • Regulated WACC : every "TURPE" period (every 4 or 5 years) • Premiums: <ul style="list-style-type: none"> ○ Fixed premium and cost incentive paid every year, ○ Commercial flows incentive calculated and paid every year, via the Regulated Account of Costs and Revenues ("CRCP") 	<ul style="list-style-type: none"> • Every 5 years, adjustment occurs 2 years later • Within period adjustment in exceptional circumstances
Reaching cap or floor	Reaching "cap" or "floor" depends on actual construction costs and actual commercial flows. Therefore, RTE faces an incentive to minimize costs. The premiums are paid once the asset is commissioned, which constitutes an implicit incentive to commission it as soon as possible.	Reaching cap or floor depends on actual construction costs and actual auction revenues. Therefore, developers face an incentive to minimize costs (including through obtaining a grant) and complete the work quickly.
Operation	Incentive to the good operation of the link, measured by the comparison between forecast and actual commercial flows (constitutes an implicit availability incentive).	Availability incentive, applied to the cap.
Regulatory treatment	Cost incentive: <ul style="list-style-type: none"> • A part of the premium is based on 	Implicit cost incentive (see above), plus: <ul style="list-style-type: none"> • Ex-post review of actual capex and re-

Regime	CRE (TURPE 4)	Ofgem (Cap and Floor)
of costs	<p>the compliance with the investment budget announced by RTE</p> <ul style="list-style-type: none"> ○ Any European grant is deducted from the actual expense to calculate RTE's cost performance. ● No other opex incentive than the general regulation framework of RTE (i.e. some opex considered non-controllable are covered on an ex-post basis, others considered as controllable are covered ex-ante). 	<p>forecast of opex to determine the final cap and floor: Ofgem will monitor the tender process.</p> <ul style="list-style-type: none"> ○ Grants are net-off from the RAV ● Pass-through revenue adjustment term for costs that developers have limited or no control over: <ul style="list-style-type: none"> ✓ Revenue adjustment (costs list based on OFTO regime), ✓ Income adjustment event (force majeure...), limited to 5 % of the floor. <p>Ofgem will investigate the developer's claim, the developer will have to show they have done all they could to limit the increase of cost items.</p> <ul style="list-style-type: none"> ● Capex incentive for Projects following Nemo could be considered

While not being incompatible with each other, each regime is designed on a different basis. The GB proposed regulation:

- Preserves the benefits of the merchant model, which are incentives to costs effective investments, within optimized cost and timelines conditions,
- and protects GB consumers from excessive returns.

The forthcoming French regulation:

- drives investments towards European social welfare improvements,
- and encourages to reduce costs and construction timelines, then checks the actual use.

The interests of French customers are preserved by the fact that an asset which would not provide, ex-post, social welfare improvement, would not receive any additional remuneration above the regulated WACC. Setting the "floor" to the regulated WACC reflects that some benefits provided are not easily quantifiable.

3. Making regulation regimes live together

The comparison of both regimes does not reveal flagrant contradictions which could make them incompatible. However, RTE considers that some potential asymmetries would need to be addressed in order to make regimes live together in a smooth way:

✓ **Regulatory treatment of costs:**

- RTE understands that, under the cap and floor regime, if capex are higher than expected, the developer's net revenues will be lowered (which constitutes an incentive to lower capex), but the cap and the floor level (in terms of revenues) will be higher thanks to the ex-post assessment so as to guarantee a constant level of minimum and maximum WACC or ROE.
- The French regime provides the same kind of incentives since the level of the premium partially depends on the actual capex.
- However, under the GB regime all costs (capex and opex) will be carefully monitored by Ofgem,
- whereas the French regime is intended to avoid costly verification process of the justification of the costs incurred by the developer.

RTE would like to have some clarifications on the way Ofgem could monitor costs for a project conducted by two parties, one of them not being regulated by the GB regime. RTE considers that further reflection will be urgently needed as regards cost regulation of interconnections linking France and GB.

✓ **Assessment period and financeability test**

RTE notes that the assessment period will strongly differ from a regime to another:

- under the French regime the assessment period, and thus the revenue adjustments, will be conducted every year with adjustment taking place the following year,
- whereas according to the cap and floor proposed regulation, assessment will occur every five years with adjustment taking place two years later, thus increasing the risks of the project.

Therefore, RTE wonders if such a discrepancy between the risks taken by developers on both ends of the link could delay or even jeopardize projects.

Moreover, the modalities of the cap and floor financeability test are currently unclear. RTE understands that Ofgem is seeking views of stakeholders on this point. RTE has no specific

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opinion on the way financeability test should be conducted, but understands that more clarity is strongly needed before a developer can undertake a project regulated by cap and floor regime.

✓ **Incentives and general regulation frameworks**

Regarding incentives (on costs, completion time and availability), and in general the whole regulation frameworks, the comparison above does not show any flagrant incompatibility between them. However, RTE considers that the interface between French and GB regulations should be carefully monitored by regulators, in order to avoid potential dissymmetric incentives.

✓ **Stability over time**

Once regulation frameworks (as the present CRE and OFGEM regimes) have been established on both sides of interconnections, and once their compatibility is ensured, they should remain stable over a sufficiently long time to provide developers with the certainty which is necessary to carry out future projects connecting GB with its neighbours.