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Your ref. 28/13
Your letter
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Dear Emmanouela,

CAP AND FLOOR REGIME FOR REGULATED ELECTRICITY INTERCONNECTOR INVESTMENT FOR APPLICATION TO PROJECT NEMO

Thank you for the opportunity to provide our views on this subject. This response represents the views of the RWE Group including its UK and Benelux generation and supply businesses. We have sent a copy of this response to CREG and the European Commission.

RWE is supportive of efforts to improve interconnection between GB and the continent which will improve wholesale market liquidity, competition and security of supply. We expect interconnectors to play a growing role in balancing supply and demand across the EU as the impact of renewable generation increases.

Although we have previously expressed a view favouring a merchant approach to DC interconnection, RWE acknowledges the issues that have led to consideration of a cap-and-floor framework as discussed in the June 2011 consultation and Ofgem's high-level principles paper of December 2011. Notwithstanding the development of the cap and floor framework, we would also like to see the pure merchant option retained. In this context we are content that Ofgem still have the objective of a "developer-led" approach.

We again underline our view that all interconnectors, whether benefiting from exemptions or not, must be required to comply with all EU Regulations, guidelines and network codes. In particular, we note that, as far as European legislation is concerned, Britned's exemption is only from Article 16(6) of the Regulation.¹ Meanwhile IFA is not a 'merchant' interconnector in this respect at all. Some consideration should, therefore, be given to applying the cap and floor treatment to IFA as well as to new investments.

We therefore oppose any form of reserve or minimum prices which, in effect, act as export taxes and form an unacceptable barrier to the internal market. In any case, minimum reserve charges are unnecessary in view of the demonstrated

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¹<http://www.ofgem.gov.uk/Markets/WhIMkts/CompandEff/TPAccess/Documents1/Britned%20amended%20exemption%20order.pdf>

earning potential from the sale of firm forward transmission rights and the revenues that will accrue to interconnector owners from implementing day-ahead market coupling. Indeed, the justification for merchant projects was always that these revenue streams would be sufficient to support the investment in question without additional restrictions and charges being necessary.

Our comments on the specific questions in the consultation are set out in the attached paper. In general, the proposed framework put forward by Ofgem appears to be sensible and reflects the nature of the risks that developers of interconnectors will be expected to take on in the new regime.

Yours sincerely,



**WILLIAM WEBSTER
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**PAUL DAWSON
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cc: Inge Bearnarts, Head of Unit, DG Energy
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CAP AND FLOOR REGIME FOR REGULATED ELECTRICITY INTERCONNECTOR INVESTMENT FOR APPLICATION TO PROJECT NEMO

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?*

We generally agree with the approach taken which is largely consistent with our response to the June 2011 consultation, that is:

- an allowed revenue approach based on costs,
- a long-term cumulative assessment of whether caps and floors have been breached over discrete periods,
- caps and floors constant in real terms,
- no profit sharing arrangements,
- performance incentives.

With respect to firmness we strongly agree that these costs should be deducted before calculating whether the cap/floor has been breached. This should prevent “firmness costs” being used as an excuse by interconnector developers to avoid providing firm access. In this respect they must comply with the Regulation and associated guidelines and network codes. Firm products will be more valuable to network users and provide more earnings for interconnector owners.

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 note the intention of Ofgem to allow for a within-period financeability test. Although this element could be a component of the regime and help protect against very negative events within periods, there is also some risk of Ofgem encouraging inefficient gearing arrangements which end up leading to higher rates of return being required simply to ensure debt covenants are met.

The arguments around cost of capital are not convincing in this respect and Ofgem should avoid disrupting the regime with the aim of encouraging investments with a particular finance structure, or from so-called “independent” investors. The proposed financeability test essentially transfers these downside risks to consumers anyway so the overall impact on them is the same. The trigger point for any within-period review should therefore be relatively strict.

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

We agree with operational incentives to ensure high availability.

The requirement to provide firm forward products which should result from the network codes will also give good incentives with respect to availability. Meanwhile we agree that any floor payments must be conditional on a satisfactory level of availability.

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

We are not convinced there is good reason to systematically worry about gaming. There are sufficient regulatory tools to deal with cases of, for example, the provision of misleading information.

Question 5: *Are there aspects of the proposed regime design for NEMO that should be reviewed for future projects, eg changes in capex treatment as more of these projects are built?*

The provision of generalised capex incentives is not likely to be a simple matter for case-by-case projects. Each project should be dealt with individually given the likely developments in technology. Clearly grants should be deducted and any soft loans should be converted into an implied investment subsidy.

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?*

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?*

The approach to have different WACC calculations at the cap and floor seems to be reasonable and a mechanistic approach should give greater investor certainty. We agree that investors should be able to retain any refinancing gains.

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?*

We agree with the approach where IDC is considered a part of the capex. Given the ex-post approach for the capex assessment, the IDC can be considered as an almost risk-free return and could be equal to the minimum return calculated for the floor.

Implications of proposed design

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

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

The overall framework appears to strike a good balance between protection against insolvency and some limited upside potential.

Interconnector investment regime – wider issues and next steps

Question 1: *Do you agree with the proposed 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?*

There may be some issues created by the contrast between the proposed first-come first-served approach to interconnector connection, and the connect-and-manage approach for new generation. This needs further consideration since the need for wider reinforcement costs further in the high voltage grid might emerge after the connection agreement has been reached as a consequence of new generation coming on stream.

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?*

We would also note that, as for all investment, the current reforms of the GB Electricity Market being prepared by the government are creating very uncertain conditions for potential interconnector developers.

We also would note that the business case for more cross-border capacity could easily be driven by different regulatory regimes on each side of the border: e.g. RES subsidy regimes, carbon taxes. If that is the case it would be wiser to align the market design when encouraging cross-border connections. Interconnectors should not become like the Euro: i.e. there is something that connects the countries but the underlying policies are not connected at all.