



AEP¹ Response to Ofgem consultation on Electricity Interconnector Policy

General

The Association of Electricity Producers (AEP) welcomes Ofgem's consultation on interconnection. Given the adoption of the Third Package and the increasing emphasis on EU electricity market integration, it is particularly timely to examine the framework for building and operating interconnectors.

AEP supports efforts to increase interconnection between the UK and neighbouring markets and to develop cross-border trade. Interconnectors can have major benefits in terms of increasing competition in national markets and promoting greater supply diversity. In the future, greater interconnection will be essential to accommodate the very large expansion of wind generation in north-western Europe required to meet the EU renewables target.

The HVDC interconnectors needed to link the GB system with other markets are capital-intensive and risky projects, which are fundamentally different from the AC lines which link most national transmission systems on the continent. In this light, it is particularly important that a stable and consistent regulatory regime is established to incentivise new interconnectors around the UK and ensure efficient use of new and existing infrastructure.

ANSWERS TO SPECIFIC QUESTIONS

Question 1.1: Have we accurately captured the benefits of or the demand for new interconnections? Are the projects under consideration all viable? Would they be sufficient? Are there other projects being developed?

The consultation covers the main benefits of interconnection: access to a wider market, security of supply, ability to accommodate more renewable generation and provision of ancillary services. More emphasis could perhaps be placed on the increased liquidity which more cross-border trade could provide, assuming that market arrangements converge, and also on diversity benefits, e.g. differing load curves and fuel mixes.

¹The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for more than 95 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable energies.

AEP does not have access to detailed information on project costs, but it seems reasonable to assume that a further 4 GW of interconnection could be in service by 2020 in addition to the projects already under construction. This would be in line with current trading patterns, price differentials between the continental/GB/All-island markets and the level of interest from developers. It would also fit in with energy policy priorities, notably market integration and renewable development.

It must be remembered, however, that interconnector projects have generally taken a considerable time to develop and build (ten years plus for BritNed), given the need to reach agreement between multiple parties (national governments, regulators, TSOs etc). Benefits may not always be evenly shared between neighbouring markets, and this can delay or even prevent projects going ahead. Moreover, lead times for national transmission reinforcement and substation construction can be extremely long. It is too early to say whether the new UK planning regime will bring the hoped-for improvements in these timescales.

Question 1.2: Are there other key aspects of the legal or regulatory framework that we should consider, or should some features be given a different emphasis?

AEP agrees that the requirements of the Third Package have to be carefully considered. In this respect it should be noted that the exemption criteria for electricity interconnectors are relatively little changed from those introduced in the 2003 Cross-Border Regulation. Nevertheless, it seems to be generally felt that the European Commission will take a more restrictive approach to exemptions in the future. As outlined below, AEP believes it important that a merchant route for interconnector remains open and that merchant projects are not discouraged through excessive regulation. Decision-making on exemptions should be transparent and consistent.

It is important that a wide variety of capacity products is offered on interconnectors. Such products should range from long-term contracts to short-term intra-day capacity, with an active secondary market to reallocate holdings. Long-term contracts (10-20 years) are an important element in reducing financial risks and should be permitted provided that they enhance competition and unused capacity is made available to the market.

If a regulated option for interconnectors is to be established, consideration will have to be given to amending the Interconnection Licence. The current Licence requires legal separation between interconnection and other activities, including transmission. However, this may not be compliant with Art. 16.6 of the EU Electricity Regulation, which envisages that interconnector congestion revenues can be taken into account in national transmission charges. It is also questionable whether business separation is efficient in the case of a regulated interconnector.

The current GB transmission charging regime is an important element of the regulatory framework which needs to be considered in Ofgem's review of interconnector policy. "Triad" charges in particular represent a major obstacle to exports from GB during the winter period. Such charges drastically reduce potential exports from GB to France during the early evening peak from November through to

February and would almost certainly have the same impact on trade across future interconnectors. Balancing Service Use of System (BSUoS) and transmission loss charges in GB also represent a barrier to trade and their application to interconnectors also needs to be examined.

AEP welcomes the fact that Ofgem has agreed to review the impact of transmission charging in the framework of the regional markets initiative. It is important that this review is carried out as a matter of priority since, if changes are to be made to the GB regime, these need to be signalled promptly to market players to give them time to adjust. In general terms, AEP takes the view that an effort will have to be made to harmonise charging methodologies across Europe if a more integrated market is to be achieved.

The consultation correctly focusses on the regulation of interconnectors developed for trading purposes. In the longer term, consideration will also need to be given to a regulatory regime for offshore grids, which will require the collaboration of the relevant national governments and regulators. Offshore grids are likely to influence the routing of “conventional” interconnectors in the future and so will take on increasing importance.

Question 1.3: How can the Regional Initiative best contribute to development or implementation of policy? Do you agree with the priorities and approach outlined?

AEP believes that the regional markets initiative provides a useful forum for discussing market integration issues. It is important that market players are involved in discussions of the regulatory framework at an early stage, rather than when projects are near to implementation.

AEP supports the list of priorities outlined in para 1.24. In particular, we would emphasise the need for further physical interconnection if the FUI region is to benefit fully from market integration. The regional initiative should therefore focus on the efficient use of interconnectors, including the removal of barriers to trade, and should develop a coherent strategy for building further links. As further interconnection comes on stream, the regional structure should adapt to reflect this.

Question 2.1: Are the target models explained in this chapter appropriate for GB? What are the issues that need to be considered? Are there alternative approaches that would be better? Will the target models effectively accommodate increased intermittency?

AEP welcomes the agreement on a “target model” at the Florence Forum and shares the view that a strategic vision is necessary to promote convergence across the EU. Nevertheless, energy markets in ten or even five years’ time are likely to look rather different from today, and so the vision should be implemented in a pragmatic way. In particular, full regulatory impact assessment and cost-benefit analysis should accompany all significant proposals for change to existing arrangements.

AEP would like to see progress made towards coupling the GB and All-Island markets with the Central-West market. This will raise difficult issues, as liquidity is concentrated at different timescales in the three markets, but the advent of the BritNed interconnector will provide a welcome impetus towards developing solutions. As mentioned above, a pragmatic approach should be taken to bringing the markets together. The differences in market design should be progressively addressed, either through harmonisation or, where this is not cost-effective, via solutions which can overcome design differences without imposing unreasonable costs.

While the proposal for day-ahead market coupling is well defined and has been implemented in practice, further work is needed to develop a target model for intra-day markets. Trading as near as possible to real time is highly desirable, given the often transient nature of price differences on interconnectors, and the development of intra-day markets should therefore be a priority.

Question 2.2: What should be our approach to firmness of interconnector capacity? Should this vary between new and existing interconnectors, or between regulated and exempt? What are the categories of costs and benefits from changing approach, where should they fall and can they be quantified?

AEP believes that TSOs should offer financially firm interconnector capacity, to allow market players to hedge transmission costs. Interruptions should be compensated at the full market spread. TSOs are clearly the best players to bear the risk of transmission failure and should not face unduly increased business risks as a result. The higher costs incurred by TSOs are likely to be offset by the fact that market players would place a higher value on interconnector capacity. Firm access would also provide TSOs with an incentive to maximise transfer capacity. To ensure a level playing field, a clear definition of force majeure should be agreed at European level.

Question 2.3: Should we seek regional solutions rather than individual project solutions for access rules, such as through a broader North West European solution for market coupling? What are the priority areas for greater regional co-ordination?

AEP supports a regional solution for the introduction of market coupling. We would like as far as possible to see a common set of principles established for all GB interconnectors. Auction arrangements should be harmonised as far as possible and there should also be a common treatment of transmission charges for interconnectors.

Question 3.1: Does this chapter capture the key issues in regulation of new electricity interconnectors? Should we assume that all new interconnectors will seek exemption?

AEP believes that the key issues are covered.

Whereas transmission infrastructure is generally built in response to need at a size designed to maintain security standards, the size of interconnectors between systems is primarily a commercial decision. There is no “right” level of capacity. Interconnectors are inherently risky projects and it does not seem logical for them to be underwritten by the market in general.

Given the high cost of DC interconnectors and concerns about regulatory uncertainty, merchant players will almost certainly seek an exemption from regulated charges. Without this, investments are unlikely to go ahead, as price capping would not be acceptable in a situation of uncertain and fluctuating returns.

Question 3.2: Of the options set out, which are preferable and why? What are the key considerations in taking forward any of the options?

AEP believes it essential that the option of building merchant interconnectors should remain open. Merchant approaches can enhance competition and security of supply by promoting investments which would not otherwise be made or bringing forward new infrastructure earlier than through the regulated route. Merchant interconnection can be an alternative to building a power station and should not therefore be subject to unnecessary regulation, provided that projects enhance competition and have adequate use-it-or-sell-it rules in place. If merchant build were ruled out, this would leave TSOs as effectively the only developers of interconnection. Decisions would be subject to regulatory approval rather than being taken on a commercial basis, increasing the risk of inefficient investment. Given the high costs of DC interconnectors, this could result in a significant burden on generators and customers at a time when several other factors are pushing prices up. AEP therefore prefers option 1.

Nevertheless, while the merchant approach is most compatible with the current GB market, AEP recognises that this may not sit well with the regulatory framework and practice in some other Member States. In this light, a regulated approach needs to be considered, even though this may reduce the scope for merchant build. Notwithstanding the disadvantages outlined above, regulated investments benefit from greater certainty and reduced financial risks and are more familiar to regulators and TSOs on the continent. As a fall-back, AEP could therefore accept option 4 if there is no prospect of a merchant line being built. We would, however, have concerns about the “hybrid” options 2 and 3, as caps would tend to increase the risks on developers and reduce the incentive to invest in interconnection.

Question 3.3: Is it feasible to have a mixture of different approaches for different interconnectors – such as some exempt and others regulated? If not, why and how should this be resolved?

In AEP's view, a mixture of approaches is feasible and indeed probably inevitable, given that exemptions already exist. Merchant lines could offer a larger proportion of long-term capacity (10-20 years), which would cover a proportion of their initial business risk and make the projects more bankable. As mentioned above, regulation of merchant infrastructure should be kept to a minimum if investment is to be encouraged.

Association of Electricity Producers, 30th March 2010