Consumer Focus
Campaigning for a fair deal

Consumer Focus response to Ofgem's consultation on electricity interconnector policy

March 2010

Summary

We welcome the chance to respond to Ofgem's consultation on electricity interconnector policy. This is a timely review, although we urge the regulator to think carefully before adopting any model that would result in consumers materially underwriting new interconnection investments – the case for such a public policy intervention has not been persuasively made.

We provide responses to the detailed questions posed in the consultation at the end of this document. To give those answers context, we first set out some broader observations on the key issues raised.

Are we different, and should we be worried if we are?

Low levels of interconnection are a characteristic of the geographically peripheral EU member states. Four of the seven least well interconnected member states are island nations (Malta, Cyprus, UK and Ireland) and the remaining three are peninsulas (Italy, Spain and Portugal). The most interconnected member state is land-locked Luxembourg.[1]

There is an aspirational target that all member states should have an interconnection capacity of at least 10 per cent of their installed generation capacity. But it should be borne in mind that:

- 10 per cent is an aspiration, not a legally binding target
- a flat aspirational target is never likely to represent the geographical practicalities of individual member states
- there may be cheaper ways of ensuring sustainable, secure and affordable energy in Britain (ie domestic generation or demand-side alternatives)

British mainland interconnector capacity is already due to rise by 60 per cent from 2,500 MW to 4,000 MW in less than two years, as BritNed (between GB and the Netherlands) and the East-West Interconnector (between GB and Ireland) come on line in 2011 and 2012 respectively.

Interconnection is a tool that may help to achieve policy goals – it should not be a policy goal for its own sake. Whether levels of interconnection need to be driven by regulatory or governmental intervention, or left to the market, really depends on whether there is a compelling public policy case for intervention.

Policy interventions are only justified where the benefits to society of intervening outweigh the costs of not doing so

Or, put more bluntly, consumers should only pick up the tab for all, or part, of the cost of financing new interconnectors if that delivers societal benefits more cheaply than the other options available to them.

We are not surprised that industry sentiment suggests that new interconnections are more likely to be built if consumers pick up some or all of the costs of risk associated with these projects. But to be confident going down that avenue, we think policy-makers would need to first be convinced that:

[1] Source: Figure 1.1, supplemented by data for Malta and Cyprus

- the construction of new interconnectors is a better way of meeting public policy aims around affordability, sustainability and security of supply than the alternatives
- these assets could not be built without consumer handouts

We do not think policy-makers are in a position to confidently answer 'yes' on either point. Though scenario building exercises like Project Discovery suggest that capacity margins will narrow markedly in the middle of the coming decade, they have not demonstrated that interconnections are the most cost-effective or timely intervention that could tackle this problem. We do not rule out such a conclusion being reached in future.

Changing market rules to cope – and coping with existing market rules

There are significant congestion rents between the UK and continental Europe[2] that, in principle, should encourage merchant investment in interconnectors in order to exploit the arbitraging possibilities arising from price differences between the markets.

It may be that changes in market rules could facilitate cross-border trading without the need for new investments to be underwritten by consumers – a potentially cheaper policy intervention. We agree with the suggestion that poor power-market liquidity is a feature in the UK, and facilitating liquid intra-day and day-ahead trading between the UK and other markets may be difficult whilst this persists.

Allowing merchant investors to sell long-term capacity rights on the interconnectors may be an alternative to revenue regulation in allowing them to underwrite their revenue streams.

It appears to us from the consultation document that the requirements of European legislation are causing a perceived 'bottleneck', discouraging further interconnections – specifically the requirement that they should be regulated unless subject to exemptions.

It is not clear to us that these regulatory requirements are entirely in the consumer interest, and they may in fact be discouraging the private sector from bearing the risk of building new interconnectors.

We would prefer interconnectors to be operated on a fully merchant basis (ie exempted) so that the full financial risk of these investments is borne by the private sector.

If new interconnections have to be revenue regulated in order to meet the requirements of European law, we would greatly favour a regulated scheme design that is 'pseudo merchant'. Such a scheme design might be characterised by the application of caps but not floors – in order that the risk of stranded assets remains with industry and is not underwritten by consumers. If floors have to be applied, these should be nugatory.

It would be interesting to look at whether the existing interconnectors are being used to their full capacity. Understanding, and optimising, their behaviours would help provide assurance that consumers are reaping the full benefits of both new and existing links.

Whatever design is eventually favoured should be balanced. It would not be acceptable for consumers to pick up all the costs of risk, while industry picks up all the profits.

[2] Amounting to €202 million in 2008 alone on the Anglo-French interconnector, according to the Commission. Source: **Third Internal Energy Market Package: Provisions regarding the Ten Year Network Development plan and European Commission perspective** (pdf 409 KB)

Views on consultation questions

Chapter 1

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

The benefits of interconnection appear to be accurately captured, although the document provides relatively limited information on the levels of demand for new interconnections.

We have no views on whether the projects under consideration are all viable, though we note that those already under construction clearly must be in the eyes of their financial backers.

Sufficiency is an almost impossible question to answer, because there is no commonly agreed benchmark to judge sufficiency against. Initiatives such as Project Discovery suggest concerns about longer-term security of supply in the UK, but it is not clear that interconnectors are a better option for providing this than (for example) building new generation assets within the UK. However, we note that levels of interconnection with GB are already scheduled to increase by 60 per cent within two years as BritNed and the East-West Interconnector come online.

We are not aware of any other projects being developed.

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?

We note that all GB interconnector projects progressed to date have been subject to exemptions from aspects of EU legislation. Exemptions, by their nature, are intended to deal with exceptional cases rather than ‘business as usual’ cases.

The continual reliance on the exemptions – coupled with the seeming ongoing willingness of the Commission to grant them – suggests that the baseline European legislation may not be adequately designed for the circumstances that the UK faces.

Is there scope to seek a ‘class’ exemption for UK interconnectors, or an agreement in principle from the Commission on circumstances where one will be granted, in order to improve investment certainty? Alternately, should we be seeking changes to the EU legislation itself?

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?

See our answer to question 1.2 above.

Chapter 2

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?

The target models appear broadly appropriate. Implicit auctions appear to be more appropriate than explicit ones the closer you get to real time, in order to avoid the complexities of running separate capacity and commodity allocation processes.

We have no views on alternative approaches.

Accommodating increased intermittency will be highly dependent on allowing trading sufficiently close to real time so that accurate forecast data for wind generation will be available.

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?

2.17 of the consultation document suggests that all interconnector capacity must be fully firm – at least financially. We have no views on whether it should be physically firm too.

We are undecided on whether a common approach to firmness should be adopted across regulated and exempt interconnectors. Consistency is generally a virtue in ensuring a level playing field, but if allowing a degree of latitude on this gives investors the additional confidence to go ahead in building an interconnection this may be a tolerable trade-off.

We oppose the socialisation of costs to customers where financial or physical firmness is not achieved. Ultimately interconnector users are not in a position to guarantee the reliability of an asset, only its operator is. It is therefore appropriate that they should bear the risk associated with it ‘falling over’.

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?

Regional solutions may provide greater investment certainty on the direction of these markets. Market coupling seems sensible in principle if we are to develop a single European energy market, though it must be noted that price coupling may only benefit GB consumers in practice if GB wholesale prices tend to run at a premium to those on the continent – in which case it should have a deflationary impact on GB wholesale prices.

Chapter 3

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 exemptions?

We think it captures the key issues.

We recommend assuming that all new interconnectors will seek exemptions – all existing ones have done so.

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?

We would prefer a solution that does not involve consumers underwriting the risk of new assets. If fully exposed to downside risk, investors may quite legitimately argue that they should have full exposure to upside benefit. We therefore think that a fully merchant model (ie option 1) is the solution most likely to find a decent balance between providing an investment environment that encourages interconnection and insulating consumers from the risks of stranded assets.

If exemptions that would allow for a fully merchant model cannot be obtained, we would favour a regulated design that, as far as possible, replicates the logic of a fully merchant model. Such a design would be characterised by a very high cap and no floor – ie such that investors can reap sufficiently high gains to give them the confidence to invest, while remaining fully responsible for any consequences of poor investment decisions. Therefore option 2 is the second most preferable of the options proposed.

Options 3 and 4 are both unattractive options for consumers because they open up the prospect of consumers underwriting the risk of investments, but if revenue floors are entirely unavoidable to allow investments to comply with European rules we suggest that these floors should be entirely nugatory – for example, a nominal £1.

The key public policy consideration in taking forward any of the options is in avoiding consumer subsidy for any interconnection unless the provision of such subsidy is clearly the best of all options available to the policy maker.

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?

We already have a mixture of approaches, so it must be feasible. Whether it is advisable or not is perhaps a different question.

Clearly as we move towards a harmonised European market it may become progressively more difficult to justify regional, or national, differences. That said, it must be borne in mind that the intention of harmonisation is to maximise societal benefits across the EU. If there are specific cases where differential treatment of a type of asset is necessary to maximise consumer benefits we would hope that policy-makers, at both national and EU level, would be sufficiently flexible to accommodate this.

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Published: March 2010

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