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Jon Parker,  
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Dear Jon,

**Response to “The regulation of future electricity interconnection: Proposal to roll out a cap and floor to near-term projects” [consultation published 23<sup>rd</sup> May 2013]**

National Grid Interconnector Holdings (NGIH) welcomes the opportunity to respond to the above consultation. NGIH, as a subset of National Grid European Business Development, is the ring fenced division within National Grid responsible for interconnector development and the management of existing operational interconnector businesses (comprising of a 50% interest in the IFA and BritNed assets). NGIH are developing several interconnector projects that aim to deliver substantial consumer benefits and assist the United Kingdom in reaching the European Commission’s proposal for a European Union interconnection target of 15% by 2030 as outlined in its Communication on European Energy Security Strategy dated 28<sup>th</sup> May 2014.

This response from NGIH covers our views as both a developer and operator of a portfolio of interconnectors. As a developer, it is our intention is to submit at least three of our projects that align with the proposed regulatory regime and assessment process, into the ‘near term project’ submission window. Namely, NSN our interconnector link with Statnett in Norway, IFA2 our interconnector to France with RTE and Viking Link to Denmark with Energinet.dk.

The proposal to roll out a cap and floor regime to near-term interconnection projects, its design and regulatory assessment framework, is welcome and timely. It enables the realisation of near-term interconnection investment and promotes the importance of interconnectors in the future electricity market in Great Britain. The proposed cap and floor approach incentivises developers to identify and progress commercially viable projects, delivering economic, environmental and security supply benefits to consumers with low project underwriting risks. We would like to highlight the need for market-led principles of the cap and floor regime to be upheld throughout the process and provide specific examples of where we feel this principle is at risk.

We note that the proposal of a cap and floor regulatory regime for near term projects is a step taken as part of the Integrated Transmission and Planning Regulation (ITPR) project, which will consult on final decisions in September this year. We look forward to continuing our engagement with Ofgem on the ITPR project, specifically the regulatory regime for interconnection beyond the near term project consultation.

With the ITPR context in mind, we would like to raise the following points with regards to both near term and future regulatory treatment of interconnection in ITPR.

- If the potential for commercially viable interconnection projects remains high in Great Britain (GB), even after near term projects are realised, continuing with the cap and floor approach and enabling a continuous window for projects to come forward, is a reasonable and appropriate consideration for longer term regulatory treatment.
- Any move away from the developer led approach should recognise investment and costs made to date and recognise existing partnerships. It should also ensure there are no unintended consequences for existing interconnectors.

Even though the timelines identified in the consultation document are challenging for all involved, we are committed and ready to meet this challenge and are planning to submit three projects for consideration. We encourage Ofgem and Government to ensure sufficient resources are available to meet these deadlines so that efficient interconnector investment and consumer benefits can be realised by 2020.

Please find our detailed response to the questions identified in the Ofgem consultation attached to this letter.

NGIH will also be replying with separate responses to the consultation with each of our project partners. We hope each of these responses demonstrates our commitment not only to the proposed Ofgem process but also specifically to achieving the connection target of 2020.

We are happy to discuss our views contained within this letter further should that be helpful. For further details, please contact Rosanna Dymoke-Grainger ([Rosanna.Dymoke-Grainger@nationalgrid.com](mailto:Rosanna.Dymoke-Grainger@nationalgrid.com)). Our response is not considered confidential. We are therefore happy for it to be placed on the Ofgem's website and shared for the purpose of the consultation.

Yours sincerely



Paul J Johnson  
Head of Development  
National Grid Interconnector Holdings

**Question 1: Do you agree that making the developer-led cap and floor regime available to near term projects would be in GB consumers' interests?**

Yes. The developer-led cap and floor regulatory treatment proposed for near term projects enables investments that are economically beneficial and commercially viable to progress. Therefore enabling consumer benefits to be realised from interconnector trading, improved security of supply and better integration of renewables. In our view, it is the only framework capable of delivering support for interconnector investment by 2020.

The regulatory certainty created by this consultation could be a significant enabler for investment, helping the United Kingdom (UK) to reach the EU's proposed target of 15% interconnection by 2030. Our studies have shown that under existing European and UK energy policies, an increase of 4 to 5 GW of new interconnector capacity could unlock around £1 billion per annum worth of benefits to energy consumers, of which 3 GW of capacity could be realised by our three projects IFA2, NSN and Viking. With wholesale prices reducing in GB between 1 to 2% with each 1 GW of new interconnection connected.

**Question 2: What are your views on the cap and floor regime design?**

Overall, the cap and floor regime proposed is positive: it provides developers incentives, based on market signals, to bring forward commercially viable projects with socio economic benefits. This limits the exposure of consumers to underwriting expensive offshore assets whilst also providing protection from the consequences of under development of capacity by sharing of revenues that exceed the cap.

We expect the cap and floor parameters to be set on a project basis such that we continue to have incentives which are consistent with developing a commercially viable project. In this way, the cap and floor regime should facilitate the proportionate sharing of risks and benefits between consumers and developers.

Therefore, as a developer with experience in risk management, we do not expect the floor revenues to be so high that the project would be viable irrespective of market valuation of the interconnector capacity. Similarly with the high risk that interconnector projects are exposed to, the cap should not be set so low that it does not reflect this increased project risk, damaging commercial viability irrespective of outcomes from sales of capacity.

It is important that the cap and floor applied to each interconnector project respects this principle of a market incentivised and developer-led approach, to bring forward commercially viable projects. As it stands, we wish to highlight specific NEMO cap and floor design aspects, where these principles are being undermined.

- The cost of debt based on the proposed benchmark is not reflective of the expected cost of debt financing for a project of this type and risk profile. We are happy to discuss and share this information with Ofgem.
- The cap benchmark based on observed Drax beta is not reflective for the cost of equity of a true merchant generator. We recommend that Ofgem adjust the cap rate upwards to strip out the effect on Drax's beta of their biomass and supply businesses.
- The annuitisation methodology distorts the equity returns achievable at the cap. The annuitisation rate needs to be increased for the equity return at cap to be as indicated by the merchant generation benchmark

- The proposed availability incentive is unnecessary as the developer is already strongly incentivised to maximise the availability of the link, through exposure to firmness costs. As it stands the developer is exposed to a double-downside that in some instances re-introduces the perverse incentive that it was designed to alleviate.
- A tax trigger should be incorporated, whereby the tax allowance can be recalculated if the tax rates changes result in a material change in the tax allowance value at any stage in the 25 years
- In addition, we recommend that Ofgem consider opportunities like ‘first of a kind’ uplifts, as these projects contain a large un-diversifiable risk, reflecting the need to create an investible regime for a new and unknown asset class.

**Question 3: What are your views on our proposed approach to the cost assessment process?**

The proposed hybrid approach to cost assessment is appropriate. We believe it allows for a proportionate view of reviewed costs and recognises that developers have a strong and commercial incentive to reduce costs of construction, thus benefiting consumers.

It is essential that the cost assessment process does not create an undue regulatory burden on projects. To ensure the process is effective, proportionate and runs efficiently, we hope to work together with Ofgem to understand their expectations, through managing the timing of the cost assessment process within individual projects.

We aim to align the cost assessment stage with our procurement process, which follows the Utilities Contracts Regulations 2006 (UCR), allowing Ofgem access to appropriate and current information and also to allow us, as a developer, to plan ahead and respond to the regulators questions in a timely manner.

**Question 4: Where do you think we may need to be flexible to accommodate the specifics of different projects and other national approaches?**

The consideration that Ofgem has made throughout the consultation to the flexibility required for each individual project is helpful, specifically when adapting the Final Project Assessment to align with individual project timelines.

The NGIH development portfolio includes a number of interconnector projects. We plan to submit three projects, NSN our interconnector link with Statnett in Norway, IFA2 our interconnector to France with RTE and Viking Link to Denmark with Energinet.dk, which we believe fit into the ‘near term project’ requirements, in the eligibility submission window.

We would like to highlight the importance of remaining in line with the proposed process and timescales, keeping in mind the need for stages of the process to align with individual projects, to ensure both developers and Ofgem certainty remains and the consumer benefits that further interconnection could bring can be delivered.

We will also be responding to this consultation with each of our partners, in individual project consultation responses. Please see these for further information about project specific considerations.

**Question 5: What are your views on the framework and processes set out in this document?**

The current framework and process proposed by Ofgem in the consultation is positive and allows for the connection target of 2020 to be met and allow for consumer benefits that further interconnection in GB could bring to be realised. Details regarding specific stages in the process and timings proposed will be covered in the subsequent questions.

**Question 6: What are your views on the timing and the information that we would require developers to submit?**

The timings outlined in the consultation proposals are both welcome but challenging, for all parties. Due to the challenging nature of the timescales, it is important that both Ofgem and developers work together to ensure they can be maintained.

The information requested for submission in the consultation document enables developers to show the maturity of project designs, with context surrounding decision making and reasoning. It also gives a positive platform to convey commercial viability, the benefits these projects could bring to consumers and hence the suitability for a cap and floor regulatory regime. We stress that any information requests and corresponding timescales should be proportionate and achievable, to ensure out project partners can be consulted.

We look forward to Ofgem informing developers how they aim to protect developer Intellectual Property as well as commercially sensitive and confidential information.

**Question 7: What are your views on our proposed eligibility test and the specific provisions that we are minded to include in such a test?**

The eligibility test outlined by Ofgem in the consultation proposal is sensible ; the short eligibility check approach will allow for developers to identify projects that are ready to move forward and aligns with the proposed timeline. We consider that all our projects meet this test, by providing information on development investment to date or pending Final Investment Decision (FID) dates that get us to 2020 connections.

**Question 8: What are your views on how we intend to assess projects at the initial and final project assessment stages?**

The proposed assessment of projects in both the Initial Project Assessment (IPA) and the Final Project Assessment (FPA) outlined in the consultation document is sensible. We would like to identify that the project comparison activity performed by Ofgem during the IPA period should align with developer led principles and allow for the market to bring forward credible and commercially viable projects, thus reducing Ofgem's role as de facto system planner. The timing of the FPA should align with each individual project timescales within its post-tender assessment procurement process. This will ensure that we, as the developer, can provide information to Ofgem through planning and engagement with our partners. Any comparisons between projects should be on the basis of transparent criteria, applied across all projects in the cohort.

Projects should not be discounted based on factors that are determined by market drivers. The responsibility of managing risks and uncertainties, such as supply chain constraints, should be left with the developer, rather than with Ofgem. Where these risks are apparent, the onus is on the developer to provide clear information on their approach to dealing with them and the likely impacts they have on project value and viability, along with risk mitigation strategies.

NGIH hope to work with Ofgem to generate clear criteria for both the comparison of projects during IPA, the information they expect from us at each stage of the process and also the timing of each stage within each individual project.

**Question 9: What are your views on the need for and timing of future windows?**

NGIH would welcome an additional window, planned for mid-2015. This additional window allows other commercially viable projects that minimise risks and maximise benefits to consumers, to be brought forward. We hope for further information and engagement from Ofgem relating to the eligibility criteria they anticipate could be applied, if additional windows were to be introduced.

The introduction of an additional window could realise benefits to consumers, with a beneficial option allowing the market to bring forward further commercially viable projects that could connect by 2020 or beyond, in the event that the ITPR considerations are still to be finalised. We deem this to be reasonable and achievable, due to the significant scope for future interconnection, in line with the EU's proposed target of 15% interconnection by 2030.

**Question 10:** What are your views on the options to protect consumers from the risk of a needs case changing between our decision to award a cap and floor and a project's final investment decisions?

On the basis that the floor revenue level on its own will not be attractive to investors, the cap and floor regime includes a fundamental incentive for developers to ensure the needs case is robust and is realised in practice. In the event that projects become non-commercially viable, consumers will be protected by developers assessing the relative merits of progressing, redesigning or withdrawing. In line with this view, it is important that the awarding of a cap and floor regulatory regime to an individual project is upheld, where the socio-economic case continues to bring benefits to consumers.

**Question 11:** What are your views regarding the next steps?

We welcome the continuous engagement identified in the next steps of the consultation. With regards the licence changes mentioned in the next step, further discussions with Ofgem covering impacts on project timescales would be helpful.

Throughout this process, and beyond, it is also important to mention that clear and transparent communication between developers and the system operator in GB is needed to deliver the required coordination of GB developments and roles and responsibilities must be determined on this basis. We hope that this will enable interconnector projects to align with system operator needs and also assist with building relationships with partner system operators with regulatory involvement. We look forward to further information from both Ofgem and the NETSO on how this will be achieved.

In addition, we would like to bring Ofgem's attention to other impacts, outside of Ofgem's remit that could affect interconnector projects. Namely DECC's work on interconnector participation in capacity mechanism (CM), which is expected to be published in September. With specific regards to the impact overall interconnector participation in the CM and corresponding auctions could have on future, and specifically near term, interconnector projects.