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Dear Jon,

The regulation of future electricity interconnection: Proposal to roll out a cap and floor regime to near-term projects

Thank you for the opportunity to respond to the above consultation. We are supportive of measures to facilitate additional interconnection where this helps to deliver security of supply cost effectively.

As you note in the Consultation Document, DECC is developing a policy solution to allow interconnected capacity to participate in the Capacity Market from 2015 and we have been engaging with DECC on this workstream. We believe that it is essential that Ofgem's proposals on interconnection should be developed in step with the work being done by the Capacity Mechanism team in DECC to ensure that the potential interactions between the two mechanisms are fully considered, thereby avoiding any risks of undue distortions or over-reward. We therefore welcome the assurance in the Consultation Document that you are in close discussion with DECC on this.

We would, however, like to highlight some possible concerns about the competitive distortions which could be created as a result of capacity using interconnectors benefiting from a cap and floor regime, while competing in a capacity auction against other generation.

Even with a cap, providing a floor price for an interconnector is a form of revenue support, which means that the risk-adjusted costs of building an interconnector will be lower than they otherwise would be. This subsidy for interconnection has the potential to create a competitive distortion between plant using a cap and floor interconnector participating in the Capacity Mechanism, and other plant, as the plant using the interconnector may not be required to pay the full costs of interconnection. This distortion is amplified by the fact that the support is funded through transmission charges, which are partly paid for by GB-based plant.

Whilst we note your initial position that any revenues accruing to interconnector developers as a result of capacity payments to interconnected capacity would be treated in the same way as other revenues, reducing the potential for over-reward, we do not consider that this eliminates the potential for distortionary impacts on the Capacity Market.

In this context, we would also seek reassurance that any possible State Aid implications have been fully considered.

Indeed, there is potential for complex interactions between the Capacity Market and the cap and floor interconnector mechanism, depending on the design of both instruments. For example, if Capacity Market penalties to interconnected capacity cause the cap and floor interconnector's revenues to drop below the floor (should there be a link between the two), then its revenues could be topped-up through increased transmission charges in GB, which, as mentioned above, will be partly funded by GB-based generators. In this scenario, GB-based plant would be compensating the cap and floor interconnector for the poor performance of its interconnected capacity.

In conclusion, we consider that Ofgem and DECC should carefully consider the potential distortionary effects that allowing interconnectors to benefit from a cap and floor regulatory regime could have on the new Capacity Market to be introduced later this year. More broadly, as you say in the Consultation Document, it is essential that any floors are set at the right level to limit the costs of the policy and avoid any undue impacts on consumers.

If you have any questions arising from our response, please do not hesitate to contact me.

Yours sincerely,



Rupert Steele
Director of Regulation