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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

SSE is pleased to respond to the interconnector consultation referenced above. We note in particular that its focus is on near-term projects with regulation of interconnector projects in the longer term being considered as part of the ITPR project (paragraph 1.28). We look forward to draft conclusions from ITPR in September.

Given the importance of electricity interconnection to the facilitation of the European energy market we are not certain that the application of a cap and floor regime is the most economic and efficient way to proceed. In our view a better solution for consumers would be to fund interconnectors in the same way as they are in other European energy markets, namely as a fully regulated transmission asset, planned and agreed either as 'one off' strategic investment or as part of the ongoing price control arrangements.

As we noted in our response last August (2013) to the ITPR "Emerging Thinking" consultation, and emphasised in our March 2014 response to the Wider Network benefit Investment consultation, we consider that fully a regulated approach to interconnectors is more consistent with integrated transmission networks in GB and across Europe in the longer term.

Such an approach still allows for competition in asset delivery and ownership, but importantly in our view makes for a common transmission network investment proposition that does not require a forced categorisation of transmission as onshore, offshore or interconnection. The requirement to model and accommodate differences in investment risk imposed by artificial categorisations can inhibit investment and realisation of more integrated markets.

Notwithstanding our comments above, we note that the cap and floor model being proposed anticipates re-openers in order to accommodate potential tee-ins and re-configuration of straight "market-to-market" interconnectors in the future. Such re-openers are clumsy and will add complexity to the organic evolution of a meshed European network.

Alignment with Transmission Framework

We welcome Ofgem's intention to align the assessment framework for assessment of new projects with the process set out under the Strategic Wider Works (SWW) mechanism for onshore transmission projects. We believe that this consistency will assist stakeholders in reviewing and commenting on documents during Ofgem's assessment process and maintain comparability between these assessments. We recognise that the interaction with other Regulatory Agencies may require the process for assessment of interconnector projects to differ slightly from that adopted through the SWW process but would recommend this is kept to a minimum.

To this end, there are a limited number of reopeners that have been adapted into SHE Transmission's licence that are likely to also be appropriate for inclusion within the mechanism, given the similarity between the construction of a new interconnector and a sub-sea transmission link.

We are concerned that some of the proposals for flexibility to work with other Regulatory Agencies may prove problematic. In particular, we are unclear how a project could be structured with different parties on respective sides of the cable without amending the licensing arrangements to incorporate defined licence areas into the interconnector licences. We would be willing to discuss this point in more detail if beneficial.

Treatment of Risk

We are unconvinced that a cap and floor regime is the most appropriate. As set out above, we believe that interconnectors should be treated as a regulated transmission asset. However, if interconnectors are to be treated as merchant assets then they should be fully subject to the competitive pressures that apply to participants of this nature.

In this regard we note the proposal that the cost of debt for the cap and floor regime will be based on a benchmark cost of equity applicable to a single generator, namely Drax[1]. This, in our view, is both a risky and unrepresentative way to proceed.

We understand that currently the WACC for Drax is in the region of 8.3%[2]. This compares with the WACC for National Grid Electricity Transmission (the primary builder of interconnectors in GB) of 4.15%[3]. We can find no justification in the consultation document for this 100% premium being offered to a (regulated) transmission asset compared to a (competitive) generator asset. One type of project, namely interconnectors, will have a cap and floor regime which mitigates the commercial risks of the project whilst the other, namely a generation project, has no such cap and floor regime so is subject to the full market risks.

Furthermore, the level of WACC varies over time. Using a single generator, rather than a basket of generators, introduces an unnecessary risk for GB consumers (as well as being wholly unrepresentative of GB generators).

[1] Footnote 21 (pg 43) in the consultation document
[2] Post tax. Source Bloomberg
[3] Post tax, for 2013/14, with an expectation that this will be lower for 2014/15.

By way of illustration the level of WACC for generation (and networks) was considered, during 2009, as part of the (BSC) P209 modification work. At that time the Drax WACC was 9.64%[4][5] compared to a network WACC applied at that time by Ofgem of 4.42% which, if the cap and floor regime had been in place then would have amounted to a 118% premium.

In addition we are not certain why interconnectors require the level of reassurance for their investment that a cap and floor regime provides. According to public statements by the CEO of the main GB interconnector developer, namely National Grid, "[GB] customers would save £1 billion a year by buying cheaper electricity from power stations"[6].

A generator takes the view, over similar timeframes as the interconnector developer, that the price between one market A (for coal or gas, for example) and another market B (the wholesale price for electricity) is such that an opportunity exists to invest in an asset (a power station or an interconnector) to realise that commercial opportunity. However, in the case of the generator they are fully exposed to the market failure risks (that the prices in market A and market B radically diverge) which, in a cap and floor regime, the interconnector does not face – rather, this risk is pasted on to end consumers.

Given this view that the price between market A and market B is such that there is a substantial opportunity, we are unconvinced that a hybrid regulated and competitive regime is required to support this investment. Under the competitive regime, parties (such as generators) weigh up the same opportunities but who have no equivalent 'cap and floor' regime to fully mitigate their risks so look for a higher return to reward their investment. In contrast, parties subject to a regulated regime derive lower returns but are exposed to less risk.

In our view much of the potential market benefit of interconnection already exists and so can be released by well developed projects that could be developed in the near-term by having a robust and fair regime, if this approach is adopted. Therefore, interconnectors should either (i) be subject to a regulated cap and floor regime with its equivalent WACC for the cost of debt based on regulated transmission assets or (ii) be free to operate in an unregulated competitive market, without a cap and floor regime.

We hope that this response will be useful and are willing to discuss any of the points raised with you or your colleagues at a mutually convenient time. We look forward to the draft ITPR conclusions in September for a long term sustainable approach that enables integrated evolution of GB transmission with that of Europe for energy security and economy.

Yours sincerely

Jen Carter
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[4] As at 30th June 2009 - source Bloomberg
[5] SSE's WACC at the same time was 8.36%.
[6] The Times, 11th June 2014.