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18 July 2014

Dear Jon

Consultation on: Proposal to roll out a cap and floor regime to near-term projects

Transmission Investment through FAB Link Limited and in partnership with RTE is developing an up to 1400MW interconnector between Britain and France, which is intended to run via the island of Alderney.

Both Transmission Investment and FAB Link Limited strongly welcome the proposal to roll out a cap and floor regime to near-term projects as this is necessary in order to allow FAB Link and other near term projects to proceed.

Whilst we are very supportive of the cap & floor regime, we consider that flexibility is required in the regime (which has essentially been designed for a balance sheet financed project being developed by two TSOs or their affiliates) to make it suitable for non-TSO developers who may be using alternative forms of financing. Allowing such flexibility should enable more competition in the provision of interconnection, lower their costs and ultimately therefore be beneficial to consumers.

In order for this flexibility not to delay those near-term projects being developed by non-TSOs, we would suggest that the Initial Assessment process be progressed on the currently proposed basis for those projects meeting the eligibility criteria, whilst in parallel the required flexibility on those aspects of the proposed regime which are not suitable for non-TSO developers is evaluated and if necessary consulted upon. The final regime (available to both TSO and non-TSO developers) should then be available in time for the Final Assessment process of a project.

We have highlighted those areas where we consider further flexibility is required, and have suggested possible adjustments in Annex A to this letter, in summary though the areas are as follows (each of which have both debt and equity considerations):

- The level of the revenue floor
- Application of the revenue floor
- Allowable costs in the cost assessment process

We will continue to work with Ofgem to provide the evidence base upon which these adjustments can be made.

Our responses to the specific questions in the consultation are contained in Annex B to this letter.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'C. Veal', written in a cursive style.

Dr Christopher Veal
Managing Partner

Annex A Cap and Floor Financial Parameters and Application

Equity considerations – level of the revenue floor

- The policy intention seems to be that equity returns should not fall below the debt return indicated by the benchmark GB Non-Financial iBoxx 10+ years to maturity bond index (the iBoxx benchmark index), however equity returns at the revenue floor level could in fact be lower the iBoxx benchmark index for the following reasons:
 - Actual costs of debt being higher than the iBoxx benchmark index
 - Allowed capital costs being less than actual capital costs (see later)
 - Allowed opex costs being less than actual opex costs
- Equity returns at the revenue floor level being at the cost of debt (or lower) would limit the pool of potential equity investors into a project
- Actual costs of debt at Financial Investment Decision (FID) will be higher than the iBoxx benchmark index due to construction risk and the single asset nature of the project
- Actual costs of debt post-commissioning are likely to be higher than the iBoxx benchmark index due to the single asset nature of the project, but could be lower than at FID if a project is refinanced
- Equity investors are incentivised to minimise the actual cost of debt (notwithstanding the existence of a revenue floor)
- A policy goal of the cap & floor regime as set out in the March 2013 consultation document¹ is that “*the regime has been designed with the intent to be open to third party investors and ensure an impartial and unbiased treatment between TSO and non-TSO developers and between existing and future developers*”.

To achieve the policy goals set out above, and to maximise benefits to consumers (by ensuring that projects with a strong cost-benefit case are actually delivered) we recommend the following approach:

- ***A project specific revenue floor return should be calculated***
- ***The revenue floor return should be calculated based upon:***
 - ***the actual gearing achieved for that project***
 - ***a floor debt return set at the actual costs of debt achieved for that project***
 - ***a floor equity return set at a level which strikes the correct balance between being low enough to provide a disincentive to developers to progress projects that are expected to perform at or near the floor, and high enough to attract new (non-TSO) investors (it may be appropriate to limit the proportion of capital to which this return is applied)***
- ***The revenue floor should be revised to take account of the revised gearing and cost of debt if a project is refinanced***
- ***It would be appropriate to reduce the cap to take account of the lower risk profile for equity investors of a revenue floor at this level***

Equity considerations – application of the revenue floor

- The consultation document proposes that the revenue floor is applied to a 5-year period with any receipts if revenues are below the floor being reimbursed by revenues above the floor during this period

¹ Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO, Ofgem, 7th March 2013

- If average revenues are below the floor during a period, a project will only be able to pay a dividend to equity investors (yield) during a 5-year period based on the level of profit from floor revenues alone
- If average revenues are above the floor level during a period, a project will only be able to pay a dividend to equity investors (yield) during a 5-year period based on the level of profit from floor revenues alone until the aggregate revenue during that period exceeds 5 years' worth of floor revenues
- At the consultation document proposed revenue floor level dividend yield to equity investors will therefore be at a low level (at or below the iBoxx benchmark index) with periodic temporary uplifts to the yield towards the end of 5-year periods
- ***At the revenue floor level proposed above dividend yields would be at or around the floor equity return with smaller periodic temporary uplifts to the yield towards the end of 5-year periods***
- ***Alternative yield smoothing mechanisms could be used but would likely be more complex***

Debt considerations – application of the floor

- The consultation document proposed level of floor would allow a certain level of debt into a project
- The consultation document proposal allows for within (5-year) period application of the revenue floor
- ***The revenue floor needs to be applied annually to meet debt service requirements***
- ***To minimise debt service reserves (and therefore total capital requirements), receipts if revenues are below the floor need to arrive within a limited time period (the longer the time period the greater the capital requirements) – the OFTO availability incentive is a good model for administering such a reconciliation: under this model any underperformance in availability in a calendar year (e.g. Jan-Dec 2014) is penalised through a reduction in revenue (from NETSO) in the following financial year (e.g. April 2015 to Mar 2016). A similar arrangement could be applied under the cap and floor regime with any payments from NETSO necessary to bring calendar-year revenues up to the floor level being paid in the following April-March period.***

Equity considerations – debt services and other reserves in allowed RAV

- The proposed cap & floor model for Project NEMO, being a balance sheet model, does not make allowances for debt service and other reserves in the Regulatory Asset Value (RAV) from which the revenue cap and floor are derived
- Debt service and other reserves (such as maintenance reserve accounts) are essential parts of a project financed capital structure
- ***Debt service reserves and other required capital reserves should be allowable items in the calculation of the Regulatory Asset Value***

Equity considerations – allowed RAV – development risk in allowed RAV

- There is no explicit allowance for development risk in the proposed cap & floor model for Project NEMO
- Development risk is stated as being allowed for through an enhanced rate of IDC compared to the OFTO generator build IDC rate (an extra 0.54%²)

² Proposed interest during construction approach for offshore transmission and Project NEMO, Ofgem, 18th October 2013, Para 2.12

- This does not take account of the need to reward development risk across a portfolio of successful and unsuccessful development projects – please see our response³ to the consultation on IDC for offshore transmission and Project NEMO
- ***The allowance for development risk should be increased to provide an overall 25% return on total development capital assuming a success rate of one in four projects (acknowledging that some of the unsuccessful projects may have been cancelled prior to FID) – for the avoidance of doubt this requires a much higher rate of return on the development expenditure on the successful project.***

³ Letter from Mr Sean Kelly, Transmission Investment, to Helen Curry, Ofgem, dated 12th November 2013

Annex B – Responses to consultation questions

Chapter Two	Proposals and policy assessment
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?	<p>Yes, there is a significant lost opportunity cost to consumers from not increasing interconnection capacity to Europe as evidenced by several recent studies⁴. It is important that this cost is removed or at least reduced as soon as possible. The merchant regime hasn't delivered any significant increase in interconnection capacity and therefore a regulated regime is required. We support the proposal to extend the cap and floor to near-term projects as the fastest way to achieve this.</p>
Chapter Three	Cap and floor regime design
Question 2: What are your views on the cap and floor regime design?	<p>Our views on the cap and floor regime design are set out in Annex A. In summary we consider that for non-TSO project financed projects:</p> <ul style="list-style-type: none"> • The floor is set too low and should be based off the weighted average of an allowed floor equity return and actual costs of debt • A higher floor should be offset by a lower cap to protect consumers interests • The floor needs to be applied annually and reconciliation payments need to be made within a short-period after the end of each revenue year
Question 3: What are your views on our proposed approach to the cost assessment process?	<p>We support the two-stage cost assessment process as both providing regulatory certainty in the short-term (that subject to a major change in project characteristics a project successful at the Initial Assessment stage will ultimately receive a regulatory cap & floor to its revenues) and leaving the final decision on cap and floor values until a later stage when firm (tender backed) costs should be available.</p> <p>We also would consider that this two stage approach should be useful in allowing time for considering the flexibility that should be allowed on a project specific basis.</p> <p>The Initial Assessment should be designed to give as much certainty as possible to developers and withdrawal of a positive view at the initial stage should only occur in the event of a major change in project characteristics.</p> <p>As such we would consider that decisions on anticipatory investment, link size, technology, connection points and route, be evaluated by Ofgem at the Initial Assessment stage and that there should not be any scope for a review of these decisions at the Final Assessment stage.</p> <p>We have always been supportive of an ex-ante capex setting the cap & floor as we believe that this leaves most construction risks with the party (the developer) best able to manage them. Whilst there is a case for allowing some ex-post adjustment to take account of a limited number of issues beyond the developers control (e.g. weather or ground risk), these need to be very tightly</p>

⁴ For example see the two studies carried out by Baringa/Redpoint for DECC: "Impacts of further electricity interconnection on Great Britain", November 2013, and "New electricity interconnection to GB – operation and revenues", February 2014

	<p>defined if the chance of a reopener is not to have a negative impact on investors' views of the regulatory risk in the regime.</p> <p>With respect to the opex assessment it will be important for project financed projects that providers of debt in particular have an indication of what the opex allowance in the floor will be. Whilst some significant opex costs (e.g. insurance) will not be able to be fixed at FID and therefore some cost uncertainty will remain at that point (and indeed thereafter), providers of debt are still likely to need to understand the expected allowance for these costs in the floor at the point of FID. We would therefore suggest that the opex and capex ex-ante assessments are carried out at the same time.</p> <p>With respect to allowable costs we have two points of concern which we set out in more detail in Annex A as follows:</p> <ul style="list-style-type: none"> • The cost assessment should take account of debt service reserves required in a project finance structure • Development risk is not adequately reflected in the cost assessment process through only a small uplift in IDC rate <p>We have reservations about the treatment of grants for which projects might be eligible. It seems a little counter-productive that if the reason that a project cannot proceed is that the equity risk in a project is too great, and if it were to be eligible for a grant, that the net effect of the treatment of the grant might be for the consumers to benefit from a risk reduction (through lower cap & floor) whilst equity providers might still be exposed to the same downside risk (i.e. a below cost of debt level of return at the floor). We would consider that grants are unlikely to be common and therefore that they should be dealt with on a case-by-case basis.</p>
<p>Question 4: Where do you think we may need to be flexible to accommodate the specifics of different projects and other national approaches?</p>	<p>Project and country specific approaches may need to be taken to reflect:</p> <ol style="list-style-type: none"> i) The form of financing that the specific project is using (e.g. project financing compared to balance sheet financing and non-TSO equity investors - please see Annex A for further detail on the issues we consider require further flexibility); ii) Potentially the proposed model for combining the regulatory approached in GB and the second country. Whilst the cap & floor regime has been developed for Project NEMO in which we understand both ends of the interconnector are to be regulated essentially in the same way (through a cap & floor mechanism), other interconnectors (such as FAB Link) are expected to have distinctly different regimes at each end (e.g. a cap & floor regime in GB and a more traditional regulated return on investment in France). To date we have not identified any incompatibilities between the two approaches but recognise that this will have to be scrutinized further as the application of the regime is worked up in more detail to ensure that any regulatory interface issues are managed appropriately.

Chapter Four	Assessment framework and process
Question 5: What are your views on the framework and processes set out in this document?	<p>We support the use of an application window as projects seeking to progress through this near-term process should already have reached a certain maturity stage and therefore be able to provide Ofgem with the required information within the allowed timescales, and moreover it should allow Ofgem to easily compare projects. We do not support applications for a pre-determined capacity level in this process as it is likely to delay the process, nor do we think a case-by-case process would be efficient for Ofgem.</p>
Question 6: What are your views on the timing and the information that we would require developers to submit?	<p>We consider that the timing looks fast but achievable which should suit all developers looking to progress their projects rapidly. With respect to information provision most of the required information should be easy to provide.</p> <p>The Cost Benefit Analysis (CBA) will require input from external market consultants (which can be costly) and possibly National Grid in its role as NETSO. Whilst we understand the need for a CBA to provide some degree of screening for projects, we would argue against this being anything other than a high level screening to demonstrate the range of potential payments/receipts to consumers given that the regime is seeking to ensure that developers retain a high level of market exposure. We note that Ofgem is allowing developers flexibility in the scenarios they model so as not to duplicate work already done and we support this – we would however seek some assurance that work to be undertaken was going to meet Ofgem’s requirements and so we will be looking to disclose potential scopes of work to Ofgem to ensure they are fit-for-purpose before the work proceeds.</p> <p>We would regard it as reasonable if Ofgem were to require further information should it be evaluating proposals to increase the level of the floor from where it is currently proposed to be set.</p> <p>We understand that Ofgem may be liaising with National Grid so that they provide information, for example on reinforcement and constraint costs, rather than requiring each developer to do this.</p>
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?	<p>We agree that the four eligibility criteria listed in paragraph 4.24 are appropriate but have concerns over the application of the connection date test if this is going to be an ongoing requirement for eligibility.</p> <p>It is common that during the development stage of a project, events may arise outside of a developer’s control which can delay the project. Under these circumstances a developer should not be in the position whereby it has to choose between maintaining an unrealistic connection date (and fulfilling the financial security requirements that entails) or forfeiting its ability to access a cap and floor regulatory model. We accept that projects which are not being pursued actively should have the risk of losing the cap and floor treatment but this should only be if the developer has mothballed or abandoned the project.</p> <p>We agree to the use of a clarification stage if data is missing or unclear but also agree that this should be restricted to a single round with relatively short time periods.</p>

<p>Question 8: What are your views on how we intend to assess projects at the initial and final project assessment stages?</p>	<p>We agree with how Ofgem intends to assess projects at the Initial Assessment stage although we note that at this stage much of the CBA information will be preliminary at best, for example projects may not have:</p> <ul style="list-style-type: none"> i) Tender backed information from suppliers; ii) Knowledge of if and how interconnectors can take part in the GB capacity mechanism. <p>Notwithstanding the above we do not have any suggestions for improving the Initial Assessment process.</p> <p>We, as will others projects, intend to commit significant development expenditure on the back of a successful Initial Assessment. As such, whilst we recognise that if the underlying project characteristics change significantly then the assessment may change, in the absence of this we would not want to be at risk of a change in assessment outcome at the final stage (although we accept that Ofgem cannot give absolute assurances in this respect we would expect it to provide whatever assurances it can).</p> <p>As with our response to question 7 above we have concerns over introducing a hard time limit between Initial and Final Assessment. We agree that as part of the eligibility assessment a credible plan for reaching FID should be shown. However, there will in many projects be delays to originally established plans and unless the developer has not been actively progressing the project we do not think it is reasonable that either there is a risk that the initial assessment decision is reviewed or that the duration of the cap and floor is reduced. We consider that should delays occur to FID and/or connection date then the developer should be required to report to Ofgem and explain what the cause of the delay has been, benchmarked against the pre-submitted project plan. Only in cases of manifest mothballing or abandonment of a project should the Initial Assessment be reviewed or the duration of the cap and floor be reduced.</p> <p>The risk of review of the Initial Assessment decision or reduction in duration of the cap and floor would increase the cost of development finance and potentially deter some developers from proceeding.</p>
<p>Question 9: What are your views on the need for and timing of future windows?</p>	<p>This is a difficult question to respond to in the absence of firm timescales for when this interim cap and floor regime is going to be replaced by the enduring ITPR solution (which may itself be a cap and floor regime or more of a centrally planned regime). If the interim regime is going to persist for some time we would suggest that Ofgem opens further windows when there is demand for them.</p>
<p>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?</p>	<p>There is a danger that Ofgem seeks not only to put the risk on a developer that there is a long-term need for a project (through a low floor and a high cap) but also seeks to decide itself whether or not there is a long-term need for a project.</p> <p>Clearly the best protection for consumers is that the developer is still very exposed to the needs case first and foremost and projects without a strong needs case will not be financed.</p>

Chapter Five	Next steps
Question 11: What are your views regarding the next steps	<p>We support the proposed next steps and we welcome Ofgem’s initiative and willingness to progress discussions on a bilateral basis whilst the consultation is on-going and until any flexibility in the arrangements proposed above have been progressed.</p> <p>It would be useful for project developers to understand the route through which cap and floor payments/receipts would be made to NETSO – for example will it be necessary for interconnector owners to become parties to the STC or can these payments/receipts be implemented through the CUSC?</p>

{End}