NeuConnect

NeuConnect Britain Limited
C/O Fulcrum
105 Piccadilly
London
W1J 7NJ

Okon Enyenhi
Networks
Ofgem
9 Millbank
London
SW1P 3GE

Mr David Inglis
Acting Chief Executive
d.inlis@meridiam.com
Direct tel +44 (0)203 006 4700
Mobile +44 (0)7841 482983

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Sent by post and email to Cap.Floor@ofgem.gov.uk

Dear Okon.

**Statutory consultation on proposed changes to the electricity interconnector licence held by National Grid North Sea Link Limited to implement the cap and floor regime ("NSL Consultation")**

Thank you for allowing us to respond to this NSL consultation.

We are responding on behalf of the NeuConnect project and the consortium's shareholders who are a participant in the cap and floor regime Window 2 process.

We understand you are seeking views on:
1) the proposed new special conditions to be inserted into the electricity interconnector licence held by NGNSL; and
2) the guidance document for the new special conditions.

General Commentary

To attract new entrants and interest in the cap and floor regime, the overall regime needs to recognise the needs and demands of project financed interconnectors as well as TSO supported balance sheet interconnectors. The guidance and licence conditions need to anticipate the 'financeabilty' and scrutiny the cap and floor regime will have from lenders and investors.

As a single asset regime connecting two different jurisdictions, the regime and any guidance needs to acknowledge differences in capital structure and funding sources as well as the construction challenges and regulatory differences of each project.

The capital sources and funding behind any project require a comprehensive fully documented end to end regulatory process and a stable regime with assurance that the floor will provide protection to investors and lenders. The regime cap needs to give investors the opportunity to share in the upside and appropriate returns commensurate with the risks of developing and operating the particular interconnector. The cap and floor regime and any guidance should reflect that individual projects will provide consumers with protection against excessive returns and that the successful operation of the interconnector will provide benefits of lower energy costs and security of supply.

Investors into the interconnector market require a return that takes into account the risk to which each individual project is exposed in terms of development, construction, operating and trading. This requires transparency and predictability to enable financing of the activities which are subject to its licence. Clear and unambiguous regime guidance and licence conditions are imperative to establish confidence and understanding by investors and debt providers.

The changes made and recent consultations around Window 2, frequently alongside other competitive transmission assets could be viewed as piecemeal changes to the cap and floor regime, without allowing interested parties to discuss common issues and find solutions for the benefit of the overall interconnector cap and floor regime as a whole. This is to the detriment of creating a clear single regime for interconnector assets which can be easily understood by potential entrants and investors.

Utilisation of a dedicated interconnector forum and consultations which represent a consideration of the entire cap and floor regime, may lead to better engagement and outcomes for Ofgem, consumers and investors in interconnectors. All Licensees need to carefully understand overall framework implications and recent consultations contain a lot of information and detailed definitions, which have to be considered in terms of the overall regime in a short consultation time frame, without dedicated resources. This prejudices smaller non-TSO investors and new entrants and creates regime uncertainty in what are already large, complex and risky infrastructure projects.

As we will comment in detail below, the Authority retains considerable discretion around the PCR process, Force Majeure and Income Adjusting Events the consequences of which will have significant impact upon Licensees. As yet no cap and floor projects are in operation and so there is little in the way of practical examples for potential entrants or investors. To establish a stable and clearly understood regime greater guidance and clarification is needed to give enhanced confidence for investors.

Turning to the special conditions themselves we wish to respond as follows: -

Special Conditions

Special Condition 2 – (Cap and Floor Level).

In considering the regime start date, we would comment that any Licensee is incentivised to complete and commission a project as soon as possible, regardless of regime start date, in order to earn revenues.

Investors who already bears the risk of construction and a post construction review, should not be further burdened by a narrow or overly draconian interpretation of an Exceptional Event (Force Majeure). The risk remains with the interconnector developer who is already heavily incentivised to commission the project to earn revenues.

The Authority should demonstrate more transparent flexibility and more detail regarding protection from Exceptional Events (Force Majeure) and flexibility around regime start date to allow greater confidence for interconnector investors.

Special Condition 4 – (Interconnector Availability Incentive).

A Licensee is always incentivised to be flowing electricity whenever possible to earn revenue.

If a Licensee fails to meet its Minimum Available Target (MAT) then as drafted, the floor is set to zero, which means a Licensee cannot fund the costs and debt of the interconnector. This is a significant and material sanction.

A risk of loss of floor may be acceptable to Groups with other assets and income, but is unattractive to project financed single asset owners or lenders with no other income to service costs and debt.

Given the length of cable in NSL, then any significant failure in its 700+km cable has a very high revenue impact and high cost of repair. A cost of repair will be highly dependent upon when and where a fault may occur, which in turn will affect availability. Any event such as an 'anchor drag' could be argued by the Authority as foreseeable and therefore not a Force Majeure event, given the broadness of interpretation of the definition.

The draconian effect of a loss of floor does not appear to fit neatly with the Authority's duty to ensure a Licensee is able to finance the activities which are subject of their licences. Insolvency and stranding of high value assets is not in consumers or investors interests.

Following a significant outage, then to get reinstatement of the Floor a Licensee must give notice to the Authority that an Exceptional Event has occurred. The Authority must then determine if an Exceptional Event has occurred and if it has been appropriately managed and mitigated. Without further guidance and specific circumstances of default being defined, such as negligence or wilful default of the Licensee; then Licensees are subject to the considerable discretion and interpretation by the Authority. During a lengthy determination of an Exceptional Event following a significant incident, then an interconnector could be considered to be trading whilst insolvent or in potential breach of its funding terms. This would create considerable risk for project financed projects if suppliers or lenders who are concerned about a significant Outage are concerned about the overall financial viability of an Interconnector.

Acceptance of an Exceptional Event does not cover the cost of repairs, which the cost of which will need to be raised or covered separately by the Licensee, Any delay in consideration of an Exceptional Event would mean investors having to make already difficult financial decisions on repair costs, whilst there may be no clear guidance as to whether the Floor will be re-instated and if the overall debt can be adequately serviced.

An Exceptional Event determination is therefore reliant upon the Authority's 'opinion' as to whether a Force Majeure Event has occurred (and been appropriately mitigated and managed by the Licensee in line with Good Industry Practice). The definition of Force Majeure within NSL's Licence is far narrower than that used for other Transmission Operators and asset owners in that it does not specifically include:

(i) Any strike action;
(ii) Nor specifically reference events such as lightning, fire, storm, flood, earthquake, explosion or failure of plant and apparatus;
(iii) Change in law.

Specifically excluded from the definition of Force Majeure is performance or non-performance by an electricity transmission licensee or equivalent entity, which is determined as not being a cause beyond the reasonable control of the Licensee. The impact of this statement is unclear, an outage by a System Operator as opposed to a Transmission Operator ('or equivalent entity') may be difficult to establish or determine, but the effect highly significant to a Licensee. A Transmission Operator itself may be able to rely upon a broader definition of Force Majeure for an event, whereas an Interconnector Licensee would not, which seems highly inequitable, particularly considering it is a single asset and not a network. The lack of guidance and scope of interpretation makes this hard for interconnector Licensees to assess the risk of a loss of floor.

Given the considerable length and therefore greater risks that an Interconnector Licensee faces then the circumstances of Force Majeure should be broader and more accommodating than other

transmission assets. Detailed guidance and examples could be made available for Licensees and investors.

The clarity around System Operator and Transmission Operator is also unclear within the definition of an "Allowed Outage". An outage caused by a TO appears excluded. This creates confusion and uncertainty for a Licensee as the distinction as to whether an outage is caused by the SO or TO and so whether a Force Majeure event is claimable or not. In either circumstance the outage is beyond the control and influence of the Interconnector Licensee who will in either event by suffering a loss of revenue caused by an outage, but risks loss of floor as well as revenue if the event is deemed to be that of the TO.

Furthermore, we would wish to comment that with BREXIT and changes to European Energy Law, UK interconnector Licensees need to be protected from changes in law that may cause outages or a loss of revenue which affect their ability to trade, which are legislative and beyond their control. A change in law which prevents flow, should not result in a loss of Floor or support for the link. Consumers benefit in the provision of these additional links in terms of lower energy costs and security of supply, so it appears inequitable that consumers are insulated from changes in law both in the UK and the jurisdiction (or EU) to which they are connected.

In the OFTO regime, any revenue reduction as a result of lack of availability is capped, which allows funding and debt service to continue. A complete loss of floor as a result of a significant event could make debt service extremely difficult for a project funded or independently owned interconnector. This risk will adversely affect the debt that can be raised and at competitive rates, for interconnector owners, which is not in the interests of consumers.

In summary, the definitions, interpretation and consequences of an Exceptional Event and Force Majeure needs further guidance and definition to enable better risk assessment by Licensees and investors.

Special Condition 7 (Non-Controllable Costs)

This condition allows for adjustments to: -

(i) Non-Controllable Operational Costs (Pass Through Adjustment) (PTA);
(ii) Income Adjusting Event (IAT);
(iii) Cap and Floor as a result of changes in legislative requirements for decommissioning. (DCC/ DCf).

The PTA adjustment, whilst described as "operational costs that may arise, but are not controlled by the Licensee", are relatively narrow in scope covering only Crown Estate Fees, GB Network and Property Rates and GB Licence Fees. Without an improved definition or guidance of Force Majeure as discussed, this creates considerable risk and uncertainty to Licensees. UK consumers take the benefit of half of all revenues under the cap and floor regime, yet the above definition of non-controllable costs does not accept similar changes to costs in the connecting jurisdiction.

The IAT (Income Adjusting Event term) is stated in the guidance to provide some "risk sharing with consumers for force majeure events", which was based upon the System Operator Transmission Owner Code (STC), but as already stated above now excludes:

i) strike, lockout or other industrial disturbance;
ii) legislative change;

Given the wider protection is provided to other Transmission operators it seems inequitable that the same benefits and protection is not afforded to complex offshore interconnector assets.

The Authority guidance also asserts that the floor provides protection to NSL from potential negative impacts on revenue arising from legislative change, including Network Codes and further development of interconnection. However, as commented above the floor is subject to considerable risk of removal as a result of missing the Minimum Availability Target (MAT), which may be beyond the reasonable control of the Licensee but does not fit within the restrictive definition or interpretation of the Authority. This creates considerable risk and uncertainty for investors and lenders of interconnector projects, without further guidance and broader definition being provided.

An IAT must constitute a Force Majeure event under the licence and any costs or expenses must exceed 5% of the floor level for a particular year for an IAT claim to be considered by the Authority. Whilst accepting that there needs to be a de minimis test for IAT to avoid small value claims it is considered that the threshold level should be set at the lesser of 5% or £100k. Requiring investors to fund IAT up to 5% of a floor in excess of £50m implies exposure of up to £2.5m. This results in a significantly greater IAT exposure for longer length interconnectors.

In summary, the application and ability to claim under this condition requires further guidance and definition to avoid ambiguity.

Special condition 8 (Process for determining the value of the Post Construction Adjustment (PCA) terms)

This process provides for the difference in the preliminary cap and floor level determination and the Post Construction Review (PCR) based on what the Authority determines as economic and efficient costs associated with developing, constructing, operating and maintaining, decommissioning an interconnector. This assessment may lead to the ultimate adjustment of the cap and floor level. The Authority shall determine the PCAC and PCAF within a period of 12 months.

The FPA process allows a detailed and transparent examination of costs and benefits of an interconnector project, after significant development costs have been expended. Independently funded projects need to be clear on the risk of any costs which may be disallowed, if a restrictive view is taken then this will result in a restricted view of costs and debt sizing as well as risk pass through to EPC contractors. This may not be in the best interests of a project or consumers. The reduction of debt and costs or excessive risk transfer remains in the overall interests of consumers.

We consider that in the absence of any cap and floor projects having achieved PCR status then the Authority should be providing more detail and structure as to what areas may be considered or re-examined post an FPA decision.

Special Condition 11 (Model Governance)

This Condition states that the Cap and Floor Financial Model (CFFM) is a stand-alone document and does not form part of the licence. The CFFM may be amended as the Authority considers necessary.

As the interconnector licence is essentially a 'price control' document, then the financial aspects of the licence should be part of the licence to allow a right of appeal to the CMA as opposed to a judicial review. The guidance should clarify the disputes procedure and right of appeal in respect of the CCFM model within the interconnector licence.

In conclusion, the Licence, guidance and definitions within the NSL Interconnector licence still contain some ambiguity on interpretation and may appear narrower or more restrictive than other transmission assets, without explanation. This ambiguity may be more tolerable to Interconnector Licensees with other assets but will be more concerning to investors and owners of single asset, project financed interconnectors. If Ofgem, wishes to encourage and invite project financed interconnectors then greater clarity and confidence will be needed in the above areas.

The above comments represent a summary of our views of the Special Conditions of the NSL Interconnector Licence. If you have any further questions or would wish us to supplement our responses above with further information, please do not to hesitate to contact me.

Yours sincerely

David Inglis
Acting Chief Executive
**NeuConnect Britain Limited**