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9th October 2018

Our Reference [OFG/CMR/001]

Dear Michael

Open Letter on the Five-Year Review of the Capacity Market Rules and NGET's incentives

Thank you for your letter of 11th September 2018 inviting views on the Capacity Market Rules ('the Rules').

In relation to your proposed priority areas for consideration we would comment as follows:-

1. We agree that Changes to the Rules could be assessed and implemented in a more efficient way. Any changes should be consulted in a transparent and open way with a suitable period for stakeholders to respond. Ofgem should be cognisant that projects and smaller entities may not have the resources to dedicate to consultation responses in short time frames.
2. We also agree that simplification of the Rules would assist all participants, but Ofgem should be aware that the participants have different regulatory regimes and so different drivers and interests. Simplification should not remove the need to ensure a 'level playing field' for all Capacity Market participants.

Interactions with BEIS Review

We have responded to the BEIS review on the Capacity Market, which in turn reflect your priority areas of change for the Rules. We consider it is worth reiterating the purpose of the Capacity Market and our overall viewpoint for your benefit in considering any changes to the Rules.

(i) Incentivise investment in capacity to ensure security of supply;

We believe that the Capacity Market does assist in providing lowest cost security of supply and has incentivised investment in new capacity and technology.

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To attract new entrants and investment, the Rules needs to recognise the needs and demands of all types of generation, interconnectors and demand side response providers, but in a way that recognises the practical issues and constraints which face each regime and technology they utilise.

The capital sources and funding behind any energy project require a comprehensive fully documented end to end regulatory process and a stable revenue stream with assurance to provide debt coverage protection to investors and lenders. The revenue earned by interconnectors is not guaranteed or necessarily predictable whilst affording the UK with the benefits of lower energy costs and security of supply. We are therefore interested in any changes in the Rules and particularly a more transparent application of any de-rating factors to maintain our investment case.

Ofgem and BEIS have encouraged and recognised the benefits of interconnectors in numerous reports and studies. All these studies recognise and encourage interconnectors as a key piece of technology to produce more secure, affordable and sustainable energy for GB. National Grid's publication on Connecting for a Smarter Future, estimates that interconnectors provide at least £11bn in benefits to GB consumers¹.

Investors into the interconnector market require a return that considers 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 transparent revenue streams applied on an equal basis are imperative to establish confidence and understanding by investors and debt providers. The calculation and application of the Capacity Market de-rating regime has not been transparent, and it is difficult to assess how the de-rating factors have been calculated.

Careful consideration needs to be given to data and information surrounding stress events and the behaviour of each relevant interconnector rather than broad assumptions or principles being applied.

The recent BEIS (Panel of Technical Experts) Final Report on National Grid's Electricity Capacity Report 2017², recommends the refining of de-rating factors for individual interconnectors rather than countries, as regional rather than country specific capacity markets tend to drive interconnector flows. In relation to the NeuConnect interconnector we would draw attention to the existing transmission network constraints in Northern Germany, which constrains renewables in the North Sea, which would be available for provision of capacity to the UK.

There is limited data and experience in relation to the contribution of interconnectors at times of system stress. Connection to new markets such as Norway, Denmark, Belgium and Germany and their respective energy markets provides significant opportunities for access to different types of generation and there is little data to support that there would be any 'double commitment' of capacity or that stress events would be correlated, particularly considering the distances in the new interconnectors being constructed, which mean stress events may

¹ <https://www.nationalgrid.com/group/about-us/what-we-do/national-grid-ventures/connecting-smarter-future>

² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/625885/PTE_Report_2017.pdf (New Recommendation 33)

not be correlated. In short, we have not seen any compelling evidence that interconnectors are any less reliable in providing capacity than other assets. Furthermore, given the complex markets, transmission networks and generation mix within connected markets, it is a broad assertion to say that all interconnectors cannot provide a reliable source of capacity.

The BEIS 2017 report also makes no change in analysis based upon exit from the EU, as the “mutual benefits of electricity trade are so large” that trade will continue. We would therefore query any unduly de-rating factor being applied particularly as we are not aware of any significant ‘stress events’ that substantiate that interconnectors are unable to deliver the necessary capacity at key times. Peak demand or high demand events do not automatically mean ‘system stress’.

We believe any studies have looked at one method in a very narrow window of GB Loss of Load Probability (3 hours per annum) and assumed stress events in connected countries with GB are highly correlated. Considering the methods of study, relating to the 10 tightest periods in each market, this approach does not appear to consider how tight the markets actually are in an absolute sense (the actual number of stress events could be increased or reduced and not effect this methodology if only load is considered). We are therefore not convinced that all methodologies used accurately reflect the actual security of supply of an interconnector into the GB market.

System response times also differ for different electricity generation and constraints on gas supplies will impact gas fired generation, which in turn may be reliant upon interconnected or imported gas supplies.

The methodology used to assess any derating of interconnectors is not detailed or provided in any level of detail and so it is difficult for us to comment in detail about the validity of any de-rating factors currently applied and whether these are appropriate. Before amending the derating factor of interconnectors then detailed studies should be produced for each existing and proposed interconnector, which the industry should be consulted upon. Amending or changing the Rules without transparency and rigour will undermine investor confidence in interconnectors at a critical time.

(ii) Provide an efficient level of capacity at a minimal cost to consumers;

We believe that cross border interconnection assists in the security of supply at an overall lower cost for consumers providing more competition in the energy and Capacity Market. Interconnection offers an export route for (low marginal cost) wind and solar from markets where for demand or network reasons these generation sources would need to be curtailed. This is to the benefit of GB consumers particularly considering some markets are likely to have renewable surplus capacity, such as Germany and Norway.

Provision of electricity across markets determined by active trading of interconnected markets provides power to GB consumers at lower prices. Additional interconnection assists the GB market in balancing intermittent wind generation as well as reducing price volatility.

We do not share the view that with a growing and changing energy system that stress events will be correlated in interconnected markets as set out above.

Any suggestion that security of supply will face diminishing returns as they are reliant upon the 'same limited pool of scarce capacity in interconnected countries' is we believe incorrect and contrary to the BEIS and Ofgem reports to date. We disagree that increased interconnection is a risk to security of supply. Given the fall in GB capacity margins, there's an equal case to be made that interconnection increases supply security by connecting GB to a larger market and to increased diversity of supply sources. Market prices will respond to tightness of supply in GB (or in other markets) and provide a signal for imports.

Cross-border sharing of balancing and ancillary services provides System Operators with more options to maintain system security than would otherwise be the case (via cooperation with other system operators) also benefits the efficient supply of capacity at minimal cost to consumers.

(iii) Complement the decarbonisation agenda.

Interconnection widely recognised as an enabling tool for more intermittent generation mixes. Interconnectors are providing security and flexibility at system level, as well as providing an export route for surplus renewable generation that would otherwise be curtailed.

Furthermore generators, wind and solar farms in Germany and GB may respond even more positively to the increased interconnection and so encourage further new investment in both countries, which meets the Capacity Market's objectives of increasing decarbonisation and incentivising investment for security of supply. The additional interconnection assists the GB market in balancing intermittent wind generation with a connection to Germany as well as reducing price volatility and costs to consumers.

As a project we are keen to attend your Stakeholder workshop on 16th November 2018 and to feed in to future consultations on the Capacity Market.

If you have any further questions or would wish us to supplement our response above with further information, please do not to hesitate to contact me.

Yours sincerely



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