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Dear Ikbal

Re: Updated minded-to position on approach to cost sharing and recovery under the CACM Regulation

We welcome the opportunity to provide our views on Ofgem's minded to position.

This response is made on behalf of National Grid Interconnectors Limited (NGIL), joint operator of the IFA Interconnector. The response is also made on behalf of our future interconnectors that have the potential to be impacted by the proposals made in the minded to letter (i.e. IFA2, NSL and Viking), as well as our 50% share in NemoLink.

Any mechanism that is ultimately determined for cost sharing and recovery must be consistent with the principles set out in CACM. In particular:

- Costs should be ultimately borne by those parties that benefit from them as per CACM Article 3(e);
- All parties incurring costs should be obligated or incentivised to ensure that they are incurred economically and efficiently as per CACM Article 3(g); and
- Where consumers or parties are bearing costs which have been incurred by other parties there must be regulatory responsibilities to ensure that these costs have been incurred economically and efficiently as per CACM Article 3(e).

In this response we set out where we agree with Ofgem's proposals and where we disagree. Where we disagree, we propose an alternative approach that we consider to be consistent with the principles of CACM.

We note that this is the second minded to position that Ofgem has issued on this subject, and we are also aware of the bilateral discussions that have taken place between Ofgem and affected market players. It is clear that there are polarised views from different industry players and Ofgem should

be striving to implement cost sharing and recovery arrangements that are appropriate, fair and, consistent with the principles above.

We set out our specific comments on Ofgem's minded to position below.

Pilot project cost recovery

We welcome Ofgem's revised proposal on Pilot project costs. We agree that 14 February 2017 should be the pilot phase end date for both pilot projects. We are pleased that Ofgem has confirmed that the scope of the pilot project costs covers both development and operational costs, including costs that were contractually committed to prior to 14 February 2017 but not actually incurred until later.

We believe that this proposal on pilot project costs is now consistent with our understanding of the letters issued by NRAs and in line with the expectations we had when entering into the pilot projects.

Enduring development costs

Ofgem's minded to proposal is that all enduring development costs (common, regional and national) incurred by NEMOs should be ultimately borne by TSOs. NGIL disagrees with this proposal, and does not agree that it is consistent with CACM.

Beneficiaries of market coupling

We note Ofgem's comments on page 9 of its letter about the beneficiaries of day ahead and intraday coupling. Ofgem acknowledges that benefits accrue to GB consumers, but also states that TSOs and NEMOs benefit '....in their respective commercial operations. TSOs, through more efficient capacity allocation, and NEMOs, by being able to offer their customers the access to the coupled day-ahead and intraday markets.'

It appears that Ofgem is implying that TSOs secure additional congestion revenues from market coupling. Ofgem has provided no analysis to support this assertion and we continue to believe that it is highly questionable to attribute additional benefits of market coupling to TSOs. Indeed, if cross-border capacity is being allocated more efficiently, then this will result in price convergence between the two connected markets, and hence lower congestion revenue.

In this context it is worth considering the objectives of the internal energy market. Recital (1) of Regulation (EC) No 714/2009 of the European Parliament and of the Council[1] states:

> *The internal market in electricity, which has been progressively implemented since 1999, aims to deliver real choice for all consumers in the Community, be they citizens or businesses,*

[1] https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0015:0035:EN:PDF

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> *new business opportunities and more cross-border trade, so as to achieve efficiency gains, competitive prices and higher standards of service, and to contribute to security of supply and sustainability.*

CACM[2] itself then, Recital (3) states:

> *Regulation (EC) No 714/2009 sets out non-discriminatory rules for access conditions to the network for cross-border exchanges in electricity and, in particular, rules on capacity allocation and congestion management for interconnections and transmission systems affecting cross-border electricity flows. In order to move towards a genuinely integrated electricity market, the current rules on capacity allocation, congestion management and trade in electricity should be further harmonised. This Regulation therefore sets out minimum harmonised rules for the ultimately single day-ahead and intraday coupling, in order to provide a clear legal framework for an efficient and modern capacity allocation and congestion management system, facilitating Union-wide trade in electricity, allowing more efficient use of the network and increasing competition, for the benefit of consumers.*

It is clear from the above that consumers are the intended beneficiaries of the internal energy market and its associated guidelines. These documents have certainly not been written with the objective of delivering benefits to Interconnector TSOs (or indeed NEMOs). In fact the network codes can restrict the level of cross-border capacity that is made available to the market, due to onshore grid constraints (via the Capacity Calculation Methodology), and impose conditions on the way that TSOs can sell their capacity to the market, both of which can detrimentally impact on the revenue earnt. Additionally, TSOs are having to use Congestion Rent to pay for the additional cost of firmness associated with market coupling.

CACM recognises that close cooperation is required between NEMOs and TSOs in order that the consumer benefits of the internal market can be realised and CACM clearly specifies the respective roles of each party. Furthermore CACM implements an institutional framework for NEMOs, requiring member states to designate at least one NEMO to perform the market coupling roles.

The costs incurred by NEMOs in performing their obligations under CACM, and their recovery route, is covered under articles 76 and 77, and there is no obligation on TSOs to pay these costs. Ofgem's proposal is inconsistent with the principles of CACM (in particular Article 3(g) on non-discrimination) and does not constitute an 'appropriate measure' as it would be understood in accordance with CACM. We elaborate on this point below.

In other European states the national TSOs will be covering the NEMO costs, but this is a pass-through to consumer via regulated tariffs. In all these cases the ultimate beneficiaries of the internal market will be paying the costs, not the TSOs. Ofgem states that the contribution from consumers for the pilot projects is appropriate, but makes no attempt to quantify or justify this statement. Under Ofgem's proposal the contribution from consumers is fixed and (will be) finalised. The proposal as written for TSOs is unquantifiable and open ended, so it is not clear how Ofgem can conclude that the fixed contribution from consumers is appropriate as, over time, under Ofgem's

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015R1222

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proposals, consumers' share of the overall costs will reduce whilst they will continue to receive the benefit.

Furthermore, Ofgem states that profits from interconnector TSOs are not shared with GB consumers. This is not the case for IFA. NGIL profits are routinely shared with consumers, and cap and floor interconnectors will return all revenue above the cap to consumers. It is worth noting that interconnector TSOs are already making significant investments to deliver day-ahead and intraday coupling. We already contribute to our share of the TSO only costs and contribute 50% of the joint TSO/NEMO costs. We also invest in our own systems to interface with the internal energy market and indeed the NEMOs. We have no route to recover any of these costs even though it could be argued that CACM envisions that we should be able to (see CACM art. 75 (1)). All of our sources of revenue are regulated and defined solely by the market and we cannot increase our prices to accommodate an increased cost base.

The only way that Interconnector TSOs could cover these costs, would be to net them off congestion revenue. The level of congestion revenue is determined by the underlying energy prices in the connected bidding zones and cannot be increased to cover the additional costs imposed on TSOs by CACM. Were TSOs simply expected to absorb the additional costs required to implement CACM then CACM would not have needed to include explicit provisions allowing cost recovery.

If Ofgem feel a pragmatic route for NEMOs to recover their costs is using Interconnector TSOs then appropriate drafting in the interconnector licences could provide a route to the NGESO for including the costs within network tariffs. However a simpler solution is for the NEMOs to interface directly to the NGESO.

Ensuring costs are efficient

In Ofgem's proposal, TSOs would be required to pay the development costs of the NEMOs. Ofgem states that this '...is limited to efficiently incurred, reasonable and proportionate costs....'. If these proposals were to be introduced, it is not clear how interconnector TSOs are in any position to determine whether the NEMO costs are efficiently incurred, reasonable and proportionate. Interconnector TSOs are not subject matter experts in the business of power exchanges, and are not competent to judge on the detail of development costs that they incur. This is a role for the Regulator, and this is confirmed in CACM itself.

Ofgem briefly describes what would happen if TSOs and NEMOs fail to reach agreement on cost items, but notes that regulatory intervention is expected to be limited. In the event that these proposals are introduced, we would expect that there would need to be significant and routine regulatory intervention to determine whether costs are efficiently incurred, reasonable and proportionate. This would be in line with Ofgem's responsibilities under CACM article 9 paragraph 8(e) to approve "capacity allocation and congestion management costs in accordance with Articles 75 to 79". Specifically, Article 75 (1) states "Costs relating to the obligations imposed on TSOs in accordance with Article 8, including the costs specified in Article 74 and Articles 76 to 79, shall be assessed by the competent regulatory authorities.".

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The appropriate solution is for Ofgem to scrutinise and approve the NEMO development costs and then pass them through to the consumer via network tariffs as CACM envisions. This is consistent with the arrangements in all other European countries and in line with objectives of CACM "ensuring fair and non-discriminatory treatment of TSOs, NEMOs, the Agency, regulatory authorities and market participants"[3].

Recovery of enduring operational costs

We believe that these costs should flow through to consumers as per our comments on development costs.

Clearing and settlement costs

We note Ofgem's proposals that these costs should be borne by NEMOs, and that this covers all of costs associated with clearing and settlement as these are clearly the tasks of the NEMOs under CACM. We note that footnote 26 states: "Except where NEMOs offer a service to a TSO in respect of management of congestion income and delivery of functions under the approved methodology on arrangements concerning more than one NEMO in a bidding zone". We assume that this refers only to services provided to TSOs where NEMOs undertake TSO tasks, and not to the full scope of the activities covered by the methodology. We do not consider that the number of NEMOs operating in the Bidding Zone should affect the proposed principle that NEMOs should bear such operational costs. Any alternative interpretation would contradict Ofgem's stated intent that NEMOs bear their own clearing and settlement costs.

Intra-TSO cost split

We note that Ofgem has included a proposal for splitting costs between TSOs. Notwithstanding our disagreement to TSOs bearing these costs in the first place, we would like to provide some comments on this element of the proposal.

The proposal needs to be clearer in relation to how new interconnectors are dealt with. Furthermore, consideration needs to be given as to how and when new interconnectors would become liable for costs in a way that avoids discrimination. If this was the date when they become operational, then this would be discriminatory against extant interconnectors who will have paid some of the development costs for systems that the new interconnectors would then interface with. They should take on obligations to contribute to a proportionate share of development costs from 15 February 2017 onwards to avoid existing interconnectors cross subsidising new interconnectors. Further clarity is also needed on the current Irish interconnectors and at what point they would contribute to the GB costs, given they are not 'new' as they are currently operational.

[3] Article 3 (e)

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We continue to support the development of the internal energy market (and the associated market coupling mechanisms) and have worked hard to try and ensure that the GB consumers will be able to continue to derive benefits from it post-Brexit. We appreciate that the issue of cost sharing and recovery is a very difficult one, and that interested parties are almost certainly going to have different views depending upon their role in the market. We hope that this response is helpful and that the principles set out on the first page are useful in determining an appropriate route for cost recovery. Please contact me if you would like to discuss any aspect of this response.

Yours sincerely

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