Response to OFGEM Consultation in relation to Interconnector Cap & Floor Regime

Aviva Investors Response

November 20th 2019

Introduction - Aviva Investors

Aviva Investors is the global asset management business of Aviva plc. The business delivers investment management solutions, services and client-driven performance to clients worldwide. Aviva Investors operates in 15 countries in Asia Pacific, Europe, North America and the United Kingdom with assets under management of £337bn as at 31 March 2019.

The infrastructure debt and equity teams are a key part of Aviva Investors' £44bn Real Assets platform (as at 31 March 2019).

The infrastructure debt team consists of 24 professionals based in London, Paris and Toronto, managing over £8bn of assets globally. Aviva Investors is one of the leading pan-European infrastructure lenders and was 3rd most active in the UK in 2018[1] after Lloyds and RBS. Aviva Investors invests on behalf of internal and external clients who are typically investing insurance annuity and pension funds.

Aviva Investors has invested in a range of regulated assets in the UK and has experience of investing in the OFTO regime over the past four years. We have followed the development of the programme for interconnector assets for a number of years and have engaged with OFGEM and a range of developers. We remain very interested in the development of such assets which may require private finance to proceed and therefore have been supportive of the continuing engagement with the financial market. This note follows our previous submission to Ofgem in April 2019.

Question 1: Do you have any views on the project finance variations requested by developers?

We have been involved in discussions with a number of developers including Greenlink and Neuconnect in relation to interconnectors and we also submitted to Ofgem our views on the regime in April 2019.

We believe the five points raised are all important matters to be considered and they represent the key issues for financial investors considering such interconnector opportunities. We note a number of these points were also acknowledged in the letter from Ofgem in 2015. Given the potential role of interconnectors in the UK energy mix and the need for an overarching plan to net zero in 2050, we support action by Ofgem to address what we consider as key investability issues.

Question 2: Do you agree with our categorisation of key and additional variations? Are there any additional factors we should consider?

We agree the five variations as set out are all key points and are discussed further below.

In terms of the additional changes requested, we will need to undertake further diligence on a number of the points raised, such as the threshold for IAEs and in particular the detail around modifications to the PCR. We would like to understand further the precise level of potential change

[1] Infranews league tables for 2018

in the floor as a result of the PCR, which does not lend itself well to a process of reaching financial close with debt sizing determined clearly at that point. Any uncertainty at this stage will lead to unnecessary/inefficient headroom to be implemented by the lenders into the financial structure.

Question 3: Is there additional evidence that we should take into account when considering the implications for consumers and developers of either granting or rejecting the key variation requests?

We consider the regime to be critical in supporting debt financing for such projects and it is important that the regime is robust and supports a fair balance of risk and reward for investors. We would refer to the CfD as an example of policy intervention that was developed to ensure low carbon projects could be delivered at an optimal cost of capital and we think a similar approach should be taken to the C&F regime.

We firmly believe that unless Ofgem is willing to consider the five key variations then the ability to raise investment into the schemes could be jeopardised and hence have an impact on the overall objective of BEIS/Ofgem to support the development of such energy generation.

Question 4: Is our approach to assessing the costs, risks and benefits of project finance variations suitable? Are there any additional factors that we should build into our assessment?

We fully understand the overarching objective as stated in 4.3 that the variations should be in the interests of the consumer. However, this needs to be balanced with the overarching business case for the development of such interconnectors and their role in the future low carbon energy market in the UK. This is no different to the challenge facing Government relating to the cost to consumers of supporting renewables or possibly nuclear or carbon capture and storage etc. We believe that it is important for Government to confirm that interconnectors are not just a possible viable option for the UK to actually being critical to the future energy mix of the UK.

Question 5: Do you have any views on the specific qualitative or quantitative analysis published in our Impact Assessment?

We understand the concept and fundamental need to assess the changes using qualitative and quantitative means but we do not feel qualified to challenge the detailed methodology.

From a pure debt perspective, we consider the regime to either provide an acceptable basis to support investment or not. In other words Ofgem's acceptance or not of the proposed variations could have a binary impact on our decision to invest, and is not necessarily a risk that could just be priced. One might thus, also in the light of our answers to Questions 6 and 7, question the probabilities attached to the scenarios of the projects being delayed but still being able to get financing in the case where Variation 4 is rejected, as we would feel that in such cases the project would have very little chances to raise financing.

Question 6: Do you agree with our proposed approval of the requests to reduce the default revenue assessment period, to make changes to the minimum availability threshold at the floor, and to broaden our definition of force majeure?

We do support the proposed approval. In terms of each variation:

<u>Default revenue assessment period</u>

We previously commented:

From a debt perspective we believe the C&F regime critically depends on the robustness of the floor in relation to the overall credit proposition. We understand the question to relate to any reserving required in relation to the 5 year review period. This periodicity increases the possibility that revenue may be under the floor for periods which is not adjusted until the review point. That could lead to reduced revenue below the floor during a 5 year period which we would require reserving to mitigate. Any such reserving will have a direct impact to the equity investors as it will be inefficient. From a debt perspective the principal issue will be the appropriate sizing of such reserves. Therefore, for financial efficiency we would support preferably an annual review period or possibly an exceptional trigger if revenue fell below the floor.

This variation is not necessarily a binary financeability issue, as the risk could in theory be managed through reserving, but in practice this would be challenging in relation to sizing the risk and hence lead to a sub-optimal financing structure and overall cost that we cannot see being value for money, bearing in mind that due to the actual payment mechanics of the floor-related amounts, a quite substantial liquidity reserve will already be needed in the case where the reduction of the assessment period to 1 year is accepted. We believe that was a modification that was indicated as acceptable in the 2015 letter issued by Ofgem.

Minimum availability

We previously commented:

We believe this is the main issue, by some distance, within the current C&F regime. As debt providers, we will look for the floor to repay the debt and hence a loss to floor revenue is material to the risk profile. We understand the tension here in terms of the impact to the consumer but in terms of financeability this is an issue that requires adjustment. Our principal concern is the fact interconnectors have not all performed well and hence we would have a genuine concern whether the manufacturers can provide sufficient support for an availability level above 80%. We would refer to the OFTO regime as a comparator structure where performance risk is capped for investors.

We believe that without a change as proposed the regime seems not be financeable from a debt perspective and hence we are very supportive of the change.

Definition of Force Majeure

We support the change. In our view, force majeure as used in the regime should apply to non-insurable events that are not under the control of the licence holder. Hence, it is important that this definition is suitably broad to cover a range of events that are currently not included and could lead to financial risk to the developer.

Question 7: Do you agree with our proposal to reject the requests to use a project-specific actual cost of debt and gearing, and to maintain a 25-year regime duration?

Project specific actual cost of debt and gearing

In terms of the project specific debt costs, we have always taken a view that the use of any notional calculations of the project financing structure and pricing should be at a minimum, and the likely actual financing structure and cost should be used rather than an academically derived assumed cost of finance. We previously commented:

The use of a notional financial structure and pricing assumptions compared to using actuals is not something that we believe has a fundamental impact to our debt proposition. This is because we would focus on the end product of the revenue floor calculated and the gearing will be driven from

this actual value. Hence this issue is more of an equity point as the equity return using the notional or actual debt structure/pricing could be very different.

We appreciate that Ofgem are concerned by not having to manage the financing process too closely and therefore, the use of a notional mechanism based on a financial structure more akin to the market expectations may be a helpful compromise.

We stress we don't think this is a debt issue but will be a key point for equity investors in terms of returns at the floor.

Our approach to the structure as a pure debt investor is focused on the determination of the actual floor revenue value as that would drive the level of debt capable of being supported by a project. By using the academic valuation, it is more likely that the actual financing structure could be sub-optimal with less debt capable of being supported, hence increasing the overall cost of capital. It is very important for us that the equity investors are adequately incentivised to support the project and we think that the proposed change may deter equity investment into such schemes. We do not think this is currently factored highly enough by Ofgem in their considerations of this proposed variation.

Conversely, were the mechanism to over-compensate investors, this would give the private sector a windfall gain, which again is not in the best interests of consumers.

Maintenance of a 25 year regime

In terms of maintaining the 25 year term:

- Firstly, as a long term debt investor we support the proposed duration and could finance this type of asset over a longer period if the regime supported it. Our main issue is that our primary capital is from a Solvency 2 insurance institutional client and in order for such assets to be deemed matching adjustment eligible, we would need to have fixed drawdowns and a fixed repayment profile. Post financial close we would have very limited flexibility relating to these constraints, and would (i) require the developers to manage around them, including payment of liquidated damages through force majeure events, and/or require from the outset a more conservative financial structure based inter alia on a shorter maturity, both leading to high degree of inefficiency.
- However, prior to financial close, we see no reason why the connection deadlines (proposed as end of 2020 for Window 1 and 2022 for Window 2) could not be extended to reflect any delay in procurement of these projects, to ensure that the cost to consumers is spread over as greater proportion of the useful life of the asset as possible.

Question 8: Do you have any views on the conclusions from our draft IA, or our early thinking on risk mitigation?

Overall, we welcome the proposed direction of travel of the regime in terms of the proposed changes. However, we remain concerned with some of the tone of the sections on conclusion and risk mitigation which stresses the objective of protecting the interests of consumers. The overall analysis needs to consider the fundamental business case for these schemes and how this fits into the Government future energy generation strategy, not least the pathway to net zero. If Ofgem accept that not all schemes can be developed by National Grid, as a regulated utility, and need project finance to progress, then the fundamental investability of the regime is critical.