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**28 November 2019**

Dear Stuart,

**National Grid Interconnector Holdings Ltd response to the Ofgem consultation on proposed changes to the electricity interconnector cap and floor regime to enable project finance solutions**

National Grid Interconnector Holdings Ltd (NGIH) welcomes the opportunity to respond to Ofgem's consultation on cap and floor variations. NGIHL is the legal entity within the National Grid group responsible for interconnector development and the management of existing operational interconnector businesses (comprising a 50% stake in the operational IFA interconnector, a 100% investment in National Grid NSN Limited (NSL), National Grid VikingLink Limited and National Grid IFA2 Limited together with a 50% interest in BritNed Development Limited and Nemo Link Limited). NGIHL, in conjunction with its partners, is investing several billions of pounds in interconnector projects that will be subject to cap and floor regulatory arrangements. A single response is being submitted reflecting our interest in all these interconnectors, regardless of their stage of development/operation or whether they are subject to cap and floor.

This response is not confidential and we are happy for Ofgem to publish it.

We have worked closely with Ofgem on the development and implementation of the cap and floor regime, most notably to date on NSL. This variations consultation reopens some issues which we have discussed in detail with Ofgem and where we considered that a final position had been reached.

Our detailed comments on the variations included in the consultation and the specific questions posed are contained within appendix 1. This covering letter considers the principles that Ofgem developed to underpin the development of the cap and floor regime.

## Cap and floor regime principles

The cap and floor regime was carefully designed by Ofgem over a number of years to balance the risks and rewards of interconnectors between developers and end consumers. A set of principles was developed to underpin the regime. These principles were first consulted upon in 2011 in relation to the regulatory regime for Nemo Link and future subsea interconnectors[1]. The high-level principles that underpinned the regime were set out as:

1. Developers should be exposed to the market's valuation of interconnector capacity;
2. Consumers should be protected from the cost implications of excessive returns or market power that might accrue to interconnector owners;
3. Developers should be able to earn returns that are commensurate with the levels of risk they are exposed to under the regulatory framework;
4. Regulatory treatment of developers should be coordinated between NRAs at either end of the shared asset; and
5. (For GB and new interconnector developments) Regulatory treatment should allow third party developers and should be impartial and unbiased between TSOs and non-TSO developers, existing and future developers

At the end of 2011, Ofgem subsequently published an open letter on 'Preliminary conclusions on the regulatory regime for project NEMO and future subsea electricity interconnector investment'[2] which re-stated the high-level regime principles as above (with the exception of the first which changed to 'Developers should be exposed to the market's valuation of interconnector capacity)'. Principles 3 and 5 above are directly relevant to this consultation and are shown in full within appendix 2.

NGIH is fully supportive of these principles, and we have always had them in mind when we have responded to Ofgem consultations, particularly in relation to the detailed licence drafting for NSL.

## The level-playing-field principle (number 5)

Alongside detailed discussions with Ofgem, we stressed in our March 2018 response to the NSL licence[3] the importance of the regime's level playing field principle. In the 2011 consultation, the implications of each principle were set out by Ofgem and for this principle, the implications included:

> *"The regime will be designed to ensure unbiased and non-discriminatory treatment between existing interconnector owners and future developers, so that there is no advantage for certain developers"*

Reliance on this principle was central to our eventual decision to accept the terms of the NSL licence and to continue with other cap and floor interconnector investment. The level-playing field principle offered us assurance that either:

- competitors would have the same arrangements; or (our preference)
- that any subsequent adjustments to allow bankability[4] must be made available to all interconnectors on a non-discriminatory basis.

[1] Cap and floor regime for regulation of project NEMO and future subsea interconnectors, page 14 https://www.ofgem.gov.uk/publications-and-updates/cap-and-floor-regime-regulation-project-nemo-and-future-subsea-interconnectors

[2] Preliminary conclusions on the regulatory regime for project NEMO and future subsea electricity interconnector investment, https://www.ofgem.gov.uk/sites/default/files/docs/2011/12/preliminary-conclusions-letter_0.pdf

[3] statutory consultation on proposed changes to the electricity interconnector licence held by National Grid North Sea Link Limited to implement the cap & floor regime: 1 March 2018 NSL Licence response

[4] Ofgem's financing duty (bankability) is detailed in its 2013 publication Ofgem financing document

In contrast this consultation's impact assessment shows a nearly £2bn (in NPV terms) reduction of consumer benefit (across all five non-NGV interconnectors) implying a c. £0.4bn advantage per non-NGV interconnector. This is a significant sum even when compared to those developers' entire construction costs and we would welcome further clarity on why:

- All four NGV cap and floor interconnectors are excluded from scope (including VikingLink which is still pre-FPA) whereas all five non-NGV projects are included (even though they could change ownership);
- Ofgem considers its approach to be fully consistent with its level playing field principle; and
- Ofgem considers that a full revaluation of the IPA process is not required to protect consumers.

**Financeability and Bankability**

We assume that the driver behind the variations in this consultation is that the relevant investors have indicated to Ofgem that their projects are not 'financeable' or 'bankable' without the variations being approved. This is a major concern to us in that we have been able to satisfy ourselves that the regime proposed for NSL is attractive enough to allow us to continue our significant investment in our portfolio of interconnectors.

Ofgem's duties are necessarily broader than the often-quoted consumer interest principle objective and includes a financing duty summarised below:

*the need to secure that licence holders can finance the activities which are the subject of obligations on them*[5]

The level playing field principle and standard regulatory practice make clear that Ofgem should have assessed bankability for all developers when implementing the regime through the Nemo and NSL licences. If developers cannot raise finance they may either be inefficient, or the regime as implemented does not support efficient investment.

We note the standard regulatory practice of using notional stand-alone structures naturally precludes discrimination between investors using different financing structures. In contrast, this consultation's proposals could promote less efficient capital structures to unlock the path to a more favourable secondary version of the regime.

Regarding this consultation, we consider that there are two different elements being:

- **Core regime elements:** These are outside the reasonable scope of a project finance variations consultation and, if made, must be available to all interconnectors on a non-discriminatory basis to avoid gifting a commercial advantage to certain developers; and

- **Genuine project finance variations** that should only be offered providing that consumers and other stakeholders are appropriately protected.

We note that no clear definition of project and balance sheet financed projects has been provided and one is required that can accommodate current and potential future ownership including disposals, acquisitions and refinancing.

[5] Para 1.7, Ofgem's duties

## a) Core regime elements

**Scope:** It is our view that elements of this consultation are outside of the project finance variations scope and would represent the reopening of the core regime and the creation of a two-tier regime. i.e. the variations scope is too broad and ill-defined to provide assurance that variations changes will avoid reopening core regime decisions.

***Principle A****: A key variations principle should therefore be that decisions made within the core regime*[6] *are outside of scope of variations to avoid conferring an advantage to certain developers. i.e. variations should be constrained by Ofgem's level playing field principle.*

This could be tested practically by offering the changes to all interconnectors on a non-discriminatory basis i.e. if variation options were specifically tailored to 'project' finance interconnectors and do not represent a competitive advantage NGV would not want to use them.

Illustrating our Principle A with protection from external events (of which the force majeure definition is part), we have raised our concerns at length that Ofgem implemented less protection than previously indicated and we would clearly also like to benefit from this potential core regime change. Otherwise NGV interconnectors would have considerably less protection than both comparable Ofgem managed regulatory regimes and competitors within the same regime.

The same reduced protection concerns were also raised by two other parties within their NSL licence consultation responses and comprehensively rejected by Ofgem with no suggestion that this may be reconsidered if a non-NGV interconnector were to make the same request.

## b) Project Finance specific regime elements

We support genuine project finance variations being made available within the constraints of the regime's clearly stated principles, Ofgem's duties and regulatory good practice.

***Principle B:*** *Asymmetric adjustments which do not disadvantage consumers or other stakeholders should be considered reasonable i.e. the changes should be set in line with Ofgem's risk-reward principle (3) which includes the following:*

> *'The levels at which the cap and floor are set should be such that the reduction in risk to investors provided by the floor compensates for the limit on returns that is created by the cap'*

A practical interpretation is that the net benefit to consumers (NPV) and that of other developers should be broadly neutral to any variation changes. Whilst this can be practically difficult to implement we have included suggested approaches with our responses to the individual variation requests.

As detailed above we have concerns over the need to ensure that our major GB interconnector investment is not placed at regulatory and commercial disadvantage through a variations process which exceeds its natural scope.

We realise that the issues and principles raised in this consultation are complex in nature, and we would be happy to meet with Ofgem to discuss any element of our response in more detail.

[6] A suitable core regime definition is any policy decision implemented within the last published Licence NSL Licence July 2018 decision

Yours sincerely

John Greasley
Regulation and Stakeholder Manager
National Grid Interconnector Holdings Ltd

**Appendix 1: Specific consultation question responses**

In responding to the consultation questions, we have focused on:

- Assessing each proposed variation in turn against the level playing field principle (Ofgem's principle 5 and our principle A) and the risk-reward principle (Ofgem's principle 3 and our principle B); and then
- The key elements of the remaining questions posed.

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

**Part 1 Key Variations 1-5** - Our views are summarised in the table below

| Variation Detail | NGIH Response | Level playing field compliant? | Risk-reward compliant? | Suggested Implementation Approach |
|---|---|---|---|---|
| **Variation 1: Reduce the default five-year revenue assessment period to one year** | This request represents a transfer of value from the cap to the floor (through a reduction in the multi-year portfolio effect) and, as such contains a degree of symmetry.<br><br>NGIH therefore does not object in principle to this project finance option being created as a variation | Yes | Yes, symmetry exists | |
| **Variation 2: Consider changes to the principle underpinning our minimum availability threshold of 80%** | We have previously raised related points which were rejected e.g. that the same 80% rate for NSL as the far shorter Nemo interconnector was unreasonable however we would not object providing that the level playing field and risk reward principles are upheld. | Yes, if limited directly to project finance surety at floor payments with appropriate symmetry<br><br>No, if other core regime considerations such as a lower threshold are bundled in or NPV symmetry cannot be delivered. | No, the IA's £2bn cost for consumer means it should not proceed without an equivalent symmetrical adjustment | The detailed change should be available to all interconnectors (clearly a lower threshold would be a regulatory advantage) and should not disadvantage consumers or other stakeholders.<br><br>This could be partly delivered by:<br><br>• Ensuring that licensees do not borrow money unnecessarily and could for example: hold back monies from good years to build up a reserve/buffer. This would reduce the chance of consumer monies being called upon.<br>• Restricting investor payments to floor returns until an appropriate reserve level is built up that licensees could then draw upon.<br>• Limiting the consumer (or any other 3rd party) default risk. |

| Variation Detail | NGIH Response | Level playing field compliant? | Risk-reward compliant? | Suggested Implementation Approach |
|---|---|---|---|---|
| | | | | It is therefore important that consumers and other stakeholders are protected from defaults and, to avoid losses where licensees are unable to repay the loans, Ofgem should directly assess the business's future capability to repay any loans prior to them being awarded. i.e. consumers should not underwrite unreliable assets and the maximum loan should be capped e.g. at a value equal to the floor.<br><br>Note: Even the above would leave consumers with a default risk. Ofgem should therefore seek a quid-quo-pro to assure NPV neutrality such as an equivalent reduction in the cost of debt or equity. |
| **Variation 3: Broaden our definition of force majeure under the default regime to include additional events necessary for enabling project finance funding** | This request represents a discriminatory reversal of previous high-profile core regime decisions and would break both the level playing field and risk-reward principles.<br><br>The core regime's protection from external events (of which the force majeure definition is part) was discussed extensively with Ofgem in relation to the NSL licence. The outcome of this left NSL with considerably less protection than we had expected based on previous policy statements and also compared with the onshore (RIIO-T1) and offshore (OFTOs) regimes.<br><br>Those concerns were also raised by two other parties within the NSL licence consultation responses (NeuConnect and FAB Link) and these were comprehensively rejected by Ofgem with no suggestion that this may be reconsidered if a non-NGV interconnector were to seek them.<br><br>To enhance protections now for non-NGV interconnectors would create a discriminatory two-tier regime and we therefore fundamentally disagree with any proposal to implement the changes for some rather than all investors. | No, core regime | Yes, the SO- TO Code definition force majeure was the original regime intent.<br><br>Note there would be an incremental cost of correcting the current asymmetry | Ofgem should therefore either offer this on a non-discriminatory basis or not at all. |
| **Variation 4: Use projects specific actual cost of debt and gearing to set the cap and floor levels, rather than the default** | There are at least two elements to this which will be considered separately.<br><br>a. For a higher IDC rate: based on the impact assessment non-NGV would expect a more favourable debt rate (175 bps mid case) than offered by Ofgem's core regime which, | Yes | No, the impact assessment's 175 bps central case cost would need to be | Consumers should not be disadvantaged by the changes and symmetry could be achieved (as with variation 1). |

| Variation Detail | NGIH Response | Level playing field compliant? | Risk-reward compliant? | Suggested Implementation Approach |
|---|---|---|---|---|
| **notional cost of debt and gearing** | which would add an estimated 2-3% to the RAV value (assumed three-year carry) and naturally increase both floor and cap returns by a similar amount. We find this enhancement of cap returns surprising in a consultation primarily aimed at providing assurance to debt investors.<br><br>b. For a higher floor rate: whilst this would not have the issue of also inflating the cap it would materially lift the floor value that consumers are underwriting thereby breaking the risk-reward principle.<br><br>Both a. and b. above would represent a material shift of value from consumers to included licensees and leave any excluded licensees at a commercial disadvantage.<br><br>Note: Whilst Ofgem already applies a view of OFTO's actual cost of finance we note that this is capped by Ofgem's view of an efficient notional structure. | | offset to protect consumers. | a. This could be resolved through introducing symmetry where for example:<br><br>The increased RAV because of the higher debt rate (than core regime) drives a higher floor level; however an equal and opposite decrease in RAV is used to calculate the cap level offsetting the licensees benefit at the floor with an equivalent reduction of value at the cap.<br><br>For example, with simplified numbers: if the core regime RAV is £500m and the variation 4 RAV is £510m then the:<br><br>• floor uses a £510m RAV (an increase on £10m); and<br>• cap applies a RAV value of £490m (an increase on £10m); creating symmetry in line with risk reward principle.<br><br>b. Symmetry could be introduced by reducing the cap rate by an amount equivalent (£m p.a.) to the increase in the floor arising from the use of an actual debt rate. |
| **Variation 5: Maintain 25-year regime length** | We have had extensive discussions with Ofgem over the 25-year regime length and the related question over the point in time until which IDC is applied.<br><br>We are concerned about the ambiguity of the 'delayed beyond developers' control criteria' potentially leading to a non-level playing field (especially since this consultation was released).<br><br>We note that most projects are now expected to become operational beyond the original planned date. Future investment would be deterred if returns are reduced (through IDC being curtailed by the Window start dates) and protection from uncertain regulation is reduced for most real-world projects.<br><br>Note: no policy has yet been made available on what regulatory framework will follow the 25-year regime. | No, core regime | Yes, a more certain regime length would retain cap and floor symmetry | As such and in line with the principles applied in this response our priority is that a level playing field is demonstrably and transparently delivered.<br><br>Our preference though is a default 25-year regime to provide mutual assurances to consumers and developers alike over the full 25-year period. i.e. that consumers will be protected from excessive returns and licensees from unsustainable losses from events outside of their control. |

**Question 1, Part 2 Additional Variations from NeuConnect and GreenLink -** Our views are summarised in the table below

| Variation Detail | NGIH Response | Level playing field compliant? | Risk-reward compliant? |
|---|---|---|---|
| **Additional non-controllable costs** | We would support this key regime implementation being revisited to return to the original principles that:<br>• all costs should be considered once (and only once in line with income will automatically be assessed within the regime); and<br>• where costs are not reasonable, manageable or forecastable then they should be considered as non-controllable rather than operating costs.<br>For example, a change in legislation which led to Network charges being levied on licensees (currently precluded by EU legislation) post the PCR assessment stage could leave a multi-million p.a. funding gap for the remaining life of the project.<br>On an FPA 'date lottery' basis those before the PCR stage would presumably be able to apply for operating cost allowances (although forecasting network charges would be a guesstimate) thereby obtaining a material regulatory advantage over previously FPA assessed projects.<br>We note that the magnitude of Network costs, if left unfunded, would potentially leave a business with a level of floor payments that was unable to finance its debt. | No, core regime | Yes, ensuring that all costs are potentially allowable would create symmetry with income.<br><br>Note there would be an incremental cost of correcting the current asymmetry |
| **'Exchange rate changes between FPA and Financial Close' and 'Modifications to the PCR'** | Enough detail is not available to comment. | Unclear | Unclear |
| **Threshold for Income Adjusting Events (IAEs)** | If this core regime decision is revisited it should be for all licensees | No, core regime | Unclear |
| **NETSO payments** | For NETSO payments we would see this as being a reasonable adjustment and good regulatory practice. | No, core regime | Yes, symmetrical and good regulatory practice extensively applied within the onshore regime. |
| **Incentives when revenues are above the cap** | Whilst we understand the logic and note the parallel to the ElecLink exemption this would be a core regime change (not a project financing variation) and, revisiting this would naturally require risk – reward principle to also be revisited. | No, core regime | No, symmetry has not been explored |

## Other consultation questions

Our views regarding the other consultation questions are summarised in the table below

| Other Consultation Questions | NGIH Response |
|---|---|
| **Question 2: Do you agree with our categorisation of key and additional variations?** | As per our question 1 responses variations 1, 2, 4 and NETSO payments are potential project financing variations which, subject to the risk-reward principle being adhered to, should be made available as an option to all developers.<br><br>The remaining 'variations' however are not specific to project finance and do not fall within the reasonable scope of this consultation. There are strong arguments for revisiting some of these areas (many of them already raised through the Nemo and NSL licence consultations) on a level playing field basis for all licensees. |
| **Are there any additional factors we should consider?** | No response |
| **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?** | As noted above the proposed changes would create a two-tier regime disadvantaging NGV's investments taken in good faith. As set out in this response, we fundamentally disagree with this approach, and Ofgem should consider the potential consequences of granting these key variation requests (e.g. having to offer them on a non-discriminatory basis to all cap and floor interconnectors) |
| **Question 4: Is our approach to assessing the costs, risks and benefits of project finance variations suitable?**<br><br>**Are there any additional factors that we should build into our assessment?** | The impact assessment lacks transparency in some areas. For example, the regime development (including IPA assessments) has not previously mentioned the risk that the regime would be implemented in an unbankable manner for most licensees and that a fundamental shift of risk to consumers would be required for them to be able to proceed.<br><br>The analysis should therefore make clear the cost of this consultation's proposals compared to the IPA assessments (we have quoted the £2.0bn based on our best interpretation of the document).<br><br>Bearing in mind the £2bn headline impact of these changes (even if ring-fenced to non-NGV) it is essential that the stakeholders can understand the reasons for this in a transparent manner. We therefore request that the analysis which Ofgem used to deliver their financeability duty for Nemo and NSL be published so that the need for the changes now proposed can be fully understood.<br><br>The monetary impact on NGV interconnectors of being placed at a regulatory and commercial disadvantage. Note: Based on the impact assessment we can crudely estimate £400m per interconnector.<br><br>With the consumer impact being so material, it is inevitable that these variations as drafted would change the IPA assessments and it is therefore difficult to see why a fuller reassessment is not required for each interconnector seeking to use the project finance version of the regime. |
| **Question 5: Do you have any views on the specific qualitative or quantitative analysis published in our Impact Assessment?** | The impact assessment lacks transparency in some areas:<br><br>For example, it is unclear why:<br><br>• being able to 'borrow' below the floor would cost £1.4bn across the 5 projects (with Ofgem actively assessing the borrowing requirement and then interest being charged) but that<br>• variation 3 (which could be the difference between having a floor or not) would only cost £11m for Greenlink and NeuConnect combined |

| Other Consultation Questions | NGIH Response |
|---|---|
| | We believe that more detail about the Impact Assessment should be made available to allow for a full consideration by affected stakeholders |
| **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?** | As covered in the responses to earlier questions we support project specific amendments which adhere to Ofgem's stated principles, policies and duties.<br><br>i.e. the default revenue assessment period is fine and the minimum availability threshold at the floor could be fine if implemented on an NPV neutral basis.<br><br>As previously stated however we object to the variations process potentially being used to create a second version of the regime made available on a discriminatory basis. |
| **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?** | As per our responses to question 1:<br>• the use of a project-specific actual cost of debt and gearing would be acceptable against the risk reward principle aligned NPV neutral basis; and<br>• maintaining a 25-year regime duration would provide greater certainty and protections for consumers and developers. |
| **Question 8: Do you have any views on the conclusions from our draft IA, or our early thinking on risk mitigation?** | As per our responses above consumers and other stakeholders deserve a clear explanation as to why such material changes are being considered so far into the regime implementation (the 3rd licence for IFA2 is currently being drafted with the previous licence acting as a firm precedent). Developers who have invested in good faith require protection from any perception that a revised, more favourable, regime will now be made available through the variations process. As such Ofgem should either:<br><br>• clearly confirm their commitment to their principles which underpin the regime;<br>• confirm how any variations can be offered on a non-discriminatory basis; or<br>• consult directly on the need to remove or amend those principles. |

## Appendix 2: Ofgem's Regime Underpinning Principles

Ofgem's regime underpinning level playing field and risk-reward principles are shown below. The most relevant text to this consultation is shown in bold.

| | |
|---|---|
| **Level playing field:** | **(For GB only and new interconnector developments) Regulatory treatment should allow third party developers and should be impartial and unbiased between TSOs and non-TSO developers, existing and future developers** |

**Why and what does this imply?**

- Appropriate incentives will be put in place to ensure that investment in new interconnection infrastructure is taken by the most suitable parties.
- The regulated investment regime will allow third party developers to participate in the establishment and operation of interconnectors.
- **Risk sharing arrangements with consumers (via the TSO transmission customer base) will be available to all potential developers on an equivalent basis.**
- **The regime will be designed to ensure unbiased and non-discriminatory treatment between existing interconnector owners and future developers, so that there is no advantage for certain developers.**
- The process of evaluation of future projects will be designed Cap and floor regime for regulation of project NEMO and future subsea interconnectors to be objective, transparent and non-discriminatory and such that it will be aimed at ensuring consumers are protected from the cost implications of excessive returns in each project.
- This does not imply that the cap and floor levels would be the same for all projects, but rather that the risks borne by customers would be proportionate to the benefits.

| | |
|---|---|
| **Risk-Reward (Ofgem and CREG):** | **Developers should be able to earn returns that are commensurate with the levels of risk they are exposed to under the regulatory framework** |

**Why and what does this imply?**

- The purpose of the cap and floor framework is to protect consumers from excessive returns, while protecting investors from downside risks.
- **The levels at which the cap and floor are set should be such that the reduction in risk to investors provided by the floor compensates for the limit on returns that is created by the cap.**
- **Additionally, the existence of a floor would provide protection to investors against the risk that potential changes in the national or European legislation (eg changes in the congestion management guidelines) could affect the business case of the project.**
- Governments see these investments in interconnectors as strategically important for meeting long term goals (security of supply, environmental sustainability, completing the internal energy market, etc).
- A symmetric approach to risk sharing, where consumers benefit from a cap, and developers from a floor, will allow investors to take a longer term view. This should reduce cost of capital, and ultimately deliver a more economically efficient resource.