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18th December 2020

Dear Mert

IFA response to 'Consultation on our assessment of IFA, BritNed and Nemo Link's pilot project and interim period cost recovery submissions under the Capacity Allocation and Congestion Management (CACM) Regulation'.

Thank you for the opportunity to respond to this consultation. This response is made on behalf of NGIC and relates to the cost recovery submission made for the IFA interconnector. This response is not confidential except for the two attached bilateral letters.

Below we provide our answers to the three questions posed by Ofgem in the consultation document.

Question 1: Do you agree with how we have assessed costs as being efficient, proportionate and reasonably incurred?

Yes.

We are pleased that Ofgem considers that 100% of the principal amount submitted by the three interconnectors is efficient, proportionate and reasonably incurred. All the costs associated with the claim of IFA are backed up by invoices, and we have also responded to a set of rigorous supplementary questions from Ofgem.

Question 2: Do you agree with our proposed cost allowances, including our approach to use Retail Price Index + Cost of Debt (RPI + CoD approach) to adjust the historical costs submitted by IFA, BritNed and Nemo Link to reflect inflation and time value of money (TVM)?

No. This issue has been discussed at length with Ofgem during the supplementary question process, and we remain of the view that our original WACC based claim is more appropriate and robust than the RPI + CoD proposed by Ofgem.

Paragraph 2.10 of the consultation document states that there was never any ex-ante agreement on how to deal with the Time Value of Money (TVM) for these costs. We would note however, that correspondence between Ofgem and National Grid in 2013 (copies of the relevant letters are attached) proposed that these costs should be dealt with through the RIIO-T1 mechanism. Whilst the RIIO-T1 return cannot be fully appropriate for IFA, these statements from Ofgem informed our consideration so, when IFA made its original claim in December 2019, we applied a TVM consistent with the WACC-based approach in RIIO-T1.

RF to MC 03.10.13.pdf

National Grid re TPCR4 European cost

In considering whether the financing costs are efficient, reasonable and proportionate we have assessed the draft decision against the relevant cost of capital principles[1] and most recent annual publication[2] issued by UK Regulators Network (UKRN) whose members, including Ofgem, are responsible for the regulation of networks across the whole of the UK. Their principles together with how we believe they have been implemented here are considered below:

- **Consistency**: This minded-to decision is not consistent with broader UK regulation including Ofgem's onshore regime. For example, TPCR4 European costs, EMR and LNG Storage operating losses recovery all used a WACC approach to calculate financing costs;
- **Risk reflective:** Full recovery of CACM related costs and the associated timing were highly uncertain until the policy decision in August 2019 and IFA has neither a price control nor floor to reduce its financing costs to that of say ETO or a cap and floor interconnector;
- **Investment**: Based on this decision all UK regulated entities would need to consider the risk of their marginal cost of finance being retrospectively deemed to be below its WACC/allowed return. This could deter investment in the absence of specific ex-ante agreed rules and processes for each required investment. This may be particularly relevant in the context of development of post-Brexit cross-border trading arrangements;
- **Communication**: as stated above, communication from Ofgem strongly implied that a WACC rate would be applied as per ETO's RIIO-T1 price control;
- **Good practice**: WACC application is standard practice for establishing the marginal cost of finance for core and ad hoc financing decisions such as CACM (uncertain recovery on unknown timescales which eventually stretched to almost a decade). Coincidently Ofgem has directly confirmed this within the recent RIIO-T2 Final Determinations published on 8 December 2020. The determination's time value of money consideration (08.12.20 RIIO-T2 FD finance annex, page 126) rejects the use of CoD as a WACC alternative and notes that a change would require engagement with other GB regulators and industry.

[1] https://www.ukrn.org.uk/wp-content/uploads/2018/11/2016MarCoC-Principles.pdf

[2] https://www.ukrn.org.uk/wp-content/uploads/2019/09/2019-UKRN-Annual-Cost-of-Capital-Report-Final-1.pdf

11.50 Whilst we see advantages to applying one consistent TVOM approach to all corrections and revisions, we recognise that the proposal to apply CoD to Totex driven revisions moves away from Ofgem regulatory practice.

- **Evidence**: No evidence has yet been shared as to why a CoD is an appropriate marginal/opportunity cost of finance for CACM cost recovery and we note that the UKRN Cost of Capital reports make no mention of CoD being an appropriate TVM; and
- **Review**: If the CACM minded-to decision holds as good practice then we would reasonably expect to see this reflected within the future UKRN Cost of Capital annual updates and regulatory price control decisions

In summary, our December 2019 claim mirrored the WACC approach taken for the main RIIO price controls along with Ofgem's treatment of TVM for other comparable processes e.g. TVM in the cap and floor regulatory framework. We therefore still consider this a more appropriate approach than the RPI + CoD approach proposed by Ofgem.

Question 3: Do you agree with our proposed approach to use the value of GBP currency for the cost recovery claims, irrespective of the currency in which these costs were incurred, including our approach to adjust BritNed's costs based on the average annual currency exchange rates for each year of its claim?

Partly. IFA incurred most of its costs in GBP and so in also having a GBP functional currency had little exposure to foreign exchange movements for CACM cost recovery. For other interconnectors who have non-GBP functional currencies the use of GBP as the denomination of claims creates a foreign exchange risk. Given the uncertainty as to the value and timing of cost recovery then it would be impossible to hedge against foreign exchange movements. We would therefore consider it more appropriate that cost recovery was considered in the originating currency and converted to GBP at the date of the final decision so that any hedging policy could be effective.

We are pleased that Ofgem has stated its intent that these costs should be recovered through the 2021 TNUoS charges cycle, and we will do everything we can to support Ofgem in making sure this happens as planned.

Please contact me if you have any questions on any aspect of our response.

Yours sincerely

By email

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