

Scott Laczay
Commercial - Interconnectors
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Scott,

CAP AND FLOOR REGIME: INITIAL PROJECT ASSESMENT OF THE GRIDLINK, NEUCONNECT AND NORTH CONNECT INTERCONNECTORS

Thank you for the opportunity to comment on the initial project assessments (IPAs) of the GridLink, NeuConnect and North Connect ('Window 2') Interconnectors.

Whilst we can see the merit in principle of promoting greater interconnection with the European Continent where projects are cost-effective and supported by a rigorous cost-benefit assessment, such joining of markets will only be economically efficient if it is based on a level playing field rather than market distortions. As you know, we consider steps still need to be taken to move towards a level playing field. In the meantime, Cap and Floor IPAs need properly to take account of any such distortions.

In that context, we have concerns over the robustness of Ofgem's overall approach to weighing up the results of its modelling. The choice of base case has a significant bearing on the overall assessment, and we are not convinced that the base case chosen for these IPAs is appropriate. In particular, we believe that the two sensitivities, 'policy' and 'capacity reduction', should in fact have been reflected in the base case, with the alternative positions as sensitivities. As explained in Annex A:

- The welfare impacts modelled in Poyry's base case are heavily influenced by the ability of interconnectors to arbitrage differences in carbon price support and BSUoS charging, whereas the 'policy' sensitivity assumes these tax and policy arbitrage opportunities are removed. The policy sensitivity should be adopted as the base case as a matter of principle. It is simply not economically efficient for UK consumers to subsidise projects (in the form of a net probability of floor payments) where the benefits of those projects depend on arbitraging UK tax and energy policy – discriminating against GB plant in favour of overseas generators. Projects should be supported only if the welfare impacts remain positive absent this arbitrage.
- In Poyry's base case, additional interconnector capacity has no impact on domestic generation capacity despite a substantial fall in average wholesale prices. In the sensitivity case, the volume of domestic generation capacity reduces – either as a result of less efficient plants exiting the market or new more efficient plants declining to enter. The latter is consistent with economic theory and seems much more probable than the base case where there is no reduction in capacity. Indeed, given

current low levels of generator profitability and the large reductions in producer surplus predicted in the base case, it seems inconceivable that generation capacity would not be affected. Poyry's estimated capacity reduction should therefore be used as the base case with 'no capacity reduction' used as a sensitivity.

In the absence of modelling results to show the impact of combining the above two sensitivities in the base case, it is possible to make a first-pass estimate from the numbers presented in the consultation, by assuming that the sensitivities are additive, as shown in the table below.

	Gridlink	NeuConnect	North Connect
Net GB consumer welfare*	1,201	400	50
GB total welfare*	-309	-633	-232

* inc system impact, £m NPV 2015, marginal approach (sensitivities assumed to be additive – see Annex A)

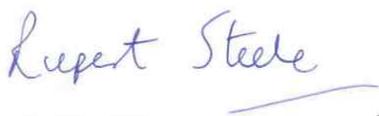
The results are particularly striking for NeuConnect and North Connect, where **the reduction in GB total welfare (a measure of the overall efficiency impact) now exceeds the gain in net GB consumer welfare**. As Ofgem has previously noted, the change in GB total welfare indicates how projects may ultimately affect consumers, once 'dynamic effects' are taken into account and markets have reached a new equilibrium.

Even if consumers see their bills reduced in the short term, the above results suggest that the position will not be sustainable and that consumer welfare would be likely to suffer over the longer term. On that basis, it is difficult to reconcile the results for NeuConnect and North Connect with Ofgem's principal objective to protect the interests of existing *and future* consumers.

We recognise that these base case modelling results are not the whole story, and that Ofgem also needs to factor in variations around the base case and non-quantifiable costs and benefits. However, it is difficult to regard Ofgem's current IPA assessments as robust in the light of these results, and we would suggest that further work is required before support for the projects is confirmed.

Please do not hesitate to get in touch should you wish to discuss this response.

Yours sincerely,



Rupert Steele
Director of Regulation

**CAP AND FLOOR REGIME: INITIAL PROJECT ASSESMENT OF THE GRIDLINK,
NEUCONNECT AND NORTH CONNECT INTERCONNECTORS
– SCOTTISHPOWER RESPONSE**

Introduction

We welcome the fact that the latest version of the Poyry assessment includes significant improvements relative to those used for the Window 1 IPAs. The inclusion of the ‘capacity reduction’ sensitivity goes some way to addressing the omission in previous IPAs of dynamic effects, and we understand that the model also now includes impacts on CfD costs and ‘cannibalisation’ of other interconnector projects.

However, despite these refinements to the modelling detail, we have concerns over the robustness of Ofgem’s overall approach to weighing up the results. The choice of base case has a significant bearing on the overall assessment, and we are not convinced that the base case chosen for these IPAs is appropriate. For the reasons set out below, we believe that the two sensitivities, ‘policy’ and ‘capacity reduction’, should in fact have been reflected in the base case, with the alternative positions as sensitivities.

Policy sensitivity

The welfare impacts modelled in Poyry’s base case are heavily influenced by the ability of interconnectors to arbitrage differences in carbon price support and BSUoS charging, whereas the ‘policy’ sensitivity assumes these tax and policy arbitrage opportunities are removed. Whilst there are good reasons to suppose that these arbitrage opportunities may indeed be removed or reduced in future (eg proposals to introduce carbon taxes in France and Germany, or possible post-Brexit border tax adjustments), the relative likelihoods of the two scenarios are more evenly balanced than in the capacity sensitivity (see below).

Our main reason for proposing the policy sensitivity as the base case is on principle. It is simply not economically efficient for UK consumers to subsidise projects (in the form of a net probability of floor payments) where the benefits of those projects depend on arbitraging UK tax and energy policy – discriminating against GB plant in favour of overseas generators. Projects should be supported only if the welfare impacts remain positive absent this arbitrage.

Capacity reduction sensitivity

Poyry consider two scenarios. In the base case, the additional interconnector capacity has no impact on domestic generation capacity despite a substantial fall in average wholesale prices. In the sensitivity case, the volume of domestic generation capacity reduces in response to falling wholesale prices – either as a result of less efficient plants exiting the market or new more efficient plants declining to enter.

The latter scenario is consistent with economic theory and seems much more probable than the base case. Indeed, given current low levels of generator profitability and the large reductions in producer surplus predicted in the base case, it seems inconceivable that generation capacity would not be affected¹.

¹ The modelled reduction in producer surplus for Window 1 (£5.0bn NPV) plus Window 2 (£5.8bn NPV) is equivalent to £642m annualised. Given estimated average CM revenues of £900m/annum during 2017-2021, it seems improbable that generators could absorb a loss of this magnitude without any capacity reduction and/or increases in CM clearing prices (we note that Poyry assume CM prices are unchanged).

Clearly there will be some uncertainty over the quantum of capacity reduction, but Poyry's estimates do not seem unreasonable, and it would seem preferable to use Poyry's figures in the base case than to assume zero capacity reduction. The 'no capacity reduction' case could reasonably be retained as a sensitivity.

Impact of using alternative base case

In the absence of modelling results to show the impact of combining the above two sensitivities in the base case, it is possible to make a first-pass estimate by assuming that the sensitivities are additive. This is shown in the table below.

	GB total welfare*			Net GB consumer welfare*		
	Gridlink	Neu-Connect	North Connect	Gridlink	Neu-Connect	North Connect
Base case	62	-254	-410	2,984	2,197	2,739
Policy sensitivity	-425	-749	-780	1,530	729	1,777
Capacity reduction sensitivity	178	-138	138	2,655	1,868	1,012
Policy + CR (assume additive)	-309	-633	-232	1,201	400	50

* inc system impact, £m NPV 2015, marginal approach

The results of combining the sensitivities are particularly striking for NeuConnect and North Connect, where the reduction in GB total welfare (a measure of the overall efficiency impact) now exceeds the gain in net GB consumer welfare. As Ofgem has previously noted, the change in GB total welfare indicates how projects may ultimately affect consumers, once dynamic effects are taken into account² and markets have reached a new equilibrium. (This might not be the case if there were sufficient excess profit in the generation sector to absorb the predicted loss of producer surplus. However, as the recent CMA Market Investigation confirmed³, this is not the case.)

Even if consumers see their bills reduced in the short term, this suggests that the position will not be sustainable and consumer welfare would suffer over the longer term. On that basis it is difficult to reconcile the results for NeuConnect and North Connect with Ofgem's principal objective to protect the interests of existing *and future* consumers.

Conclusions

We recognise that these base case modelling results are not the whole story, and that Ofgem also needs to factor in variations around the base case and non-quantifiable costs and benefits. However, it is difficult to regard Ofgem's current IPA assessments as robust in the light of these results, and we would suggest that further work is required before support for the projects is confirmed.

ScottishPower
16 August 2017

² <https://www.ofgem.gov.uk/ofgem-publications/93792/ipamarch2015consultation-final-pdf>, footnote 1

³ "Our analysis of the profitability of the generation operations of the Six Large Energy Firms between 2009 and 2013 indicates returns that are generally in line with or below the cost of capital once adjustments are made to reflect the deprival value of the assets." CMA Final Report, para 4.86