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Dear Stuart

Consultation on proposed changes to the electricity interconnector cap and floor regime to enable project finance solutions.

SSE welcomes the opportunity to provide feedback on the above consultation. SSE is supportive of initiatives which work towards meeting the demands of one of Ofgem's key priorities from the Forward Work Programme 2019-2021; enabling future markets and system arrangements. We believe it is important, as society works towards a net-zero target in 2050¹, that Ofgem support developments which will ultimately help move Britain towards this target.

It is the opinion of SSE that, where there is true consumer benefit, a degree of flexibility should be offered to enable the realisation of a project. However, SSE cannot support varying a support scheme, to reduce the risks to developers of projects, which are no longer in GB consumers best interests as a result of market changes. To that end we consider that it may be prudent for Ofgem to revisit the 'needs case' and to recalculate the total GB consumer benefits to confirm that these projects will realise the expected benefit to consumers.

Our responses to the individual questions in the consultation can be found in Appendix 1 of this document.

SSE would welcome the opportunity to discuss the key themes from this consultation further with Ofgem and would like to offer the possibility of a meeting at either SSE's or Ofgem's London or Glasgow offices for this purpose.

Your sincerely

Fiona Morrison
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¹ <https://www.gov.uk/government/news/uk-becomes-first-major-economy-to-pass-net-zero-emissions-law>

Appendix 1 – Questions

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

Variation 1 - Reduce the five year revenue assessment period to one year.

SSE recognises that allowing this variation could offer benefit to consumers in the long-run as it may offer developers the ability to secure lower cost capital. Any flexibility which would in turn impact capital costs to the extent of potentially reducing these should be considered.

We would however advocate that as well as an annual revenue assessment there should also be a five-year review period offering assurances that GB consumers are receiving value for money on an ongoing basis. Simply moving to an annual assessment could transfer more risk to consumers which may outweigh any reduction to the cost of capital which the developer could secure. In this model a single year shortfall could be followed by four years of revenue at the cap. Removing exposure to this scenario significantly increases the developer's revenue potential.

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

Whilst we agree with Ofgem that the "additional" variations are less likely to have an impact on the financeability of projects in the way that the identified "key" variations could, we do have concerns with the perceived secondary nature of these variations within this consultation.

While Ofgem consider it "beyond the scope" to consider how these variations may impact future projects it should be recognised that the decisions made at this time are likely to be considered to set a precedent for future variation requests.

To that end we have made comments against each request below:

Greenlink Request	SSE Comments
Additional non-controllable costs	SSE believes that developers of critical infrastructure should be mature to the possibility of macro-changes, such as to laws, regulations or corporation tax. However, we believe that Ofgem should be open to considering such matters on a project-by-project basis while maintaining a degree of flexibility. Many of these changes are outside of the developer's control and, due to the number of possible variations, cannot be efficiently modelled when assessing project costs over the long lifetimes of these types of projects.
Exchange rate changes between FPA and financial close	SSE considers that exchange rate fluctuations should already be included within the developers hedging strategy, which is an allowable cost, therefore to receive a further benefit from this should not be permitted.

Threshold for Income Adjusting Events	This proposal would align the IAE under the cap and floor regime to the existing OFTO regime. SSE therefore disagrees with Ofgem's minded to reject position. Consistency across regimes, where possible, is beneficial to developers of all types of asset.
Incentives when revenues are above the cap	This suggestion is a direct contradiction to the fundamental nature of the 'cap and floor' regime. Developers have the guarantee of revenues above the floor however this is limited by the cap. A sharing mechanism above the cap could lead to GB consumers being worse off, as they are expected to top-up a project's revenues to the floor level but do not receive the full benefit when the cap level is exceeded. Additionally, this suggestion could, potentially, lead to developers seeking to artificially lower the cap level to allow themselves to take advantage of the revised revenue sharing mechanism.

NeuConnect Request	SSE Comments
Modifications to the PCR	One concern which arises from the suggestion that the PCR process only considers costs uncertain at FPA, is that this allows changes to costs, accepted at the FPA stage, to fly under the radar and not be reallocated during the PCR stage.
NETSO Payments	SSE would agree with Ofgem that this variation would introduce an additional, unnecessary, complexity to the regime. Additionally, it is not clear how this would benefit GB consumers.

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?

Taking the regulation as given, there is no further evidence which should be taken into account when assessing these variations.

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?

Taking the regulation as given, there are no further considerations which should be factored into the assessment.

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

SSE does not have any comments on the qualitative and quantitative analysis published in the Impact Assessment.

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?

Variation 2 - Consider changes to the principle underpinning the minimum availability threshold of 80%.

Ofgem's proposal to approve variation 2 is surprising. Of concern is the risk that consumers would be penalised across multiple fronts in years when the interconnector does not meet the 80% threshold. Ofgem's analysis suggests that in a competitive market, interconnectors are expected to reduce the GB wholesale electricity price(s). Therefore, should an interconnector not meet the 80% availability threshold, GB consumers would likely be exposed to higher GB wholesale costs along with the additional costs of funding the floor price of the interconnector. Additionally, it is conceivable that, due to other fluctuating costs, GB consumers may see a significant increase, but limited decrease, in their costs.

We are also disturbed by the indication that, at the outset of a new project, a developer deems it unlikely that its asset will meet the 80% availability threshold- a threshold which by Ofgem's own admission is binary in nature, and which SSE considers is not challenging to start with. By its very nature the cap and floor regime already gives a strong guarantee that a developer will earn revenue from its asset when compared, for example, with a merchant build interconnector². We recognise that debt lenders look for stability and predictable return when extending loans to developers. However, where the developer of a brand new asset is unable to provide sufficient assurance that said asset will be available more the four fifths of the time, GB consumers should not be made to shore up the developer's case; not least because of the 'moral hazard' that could arise otherwise, whereby the developer is not incentivised to install / procure a technically robust solution as their revenue is secured by the cap and floor regime.

Utilised in this manner, the threshold is offering the wrong incentive on the developer, and in this case, is arguably, leading to the developer speculating against the floor price. We would consider this to represent a perverse incentive as there is no reason for the developer to make economically efficient decisions during development, construction and operation.

Variation 3 – Broaden the definition of force majeure under the default regime to include additional events necessary for enabling project finance funding.

Looking at the specific requests, the perception is that developers are looking to Ofgem to provide a form of contractual underwriting, protecting them from 'unpredictable' incidents. However, the very definition of a force majeure event is that the event could not have been anticipated or controlled. By including the incident within a predefined list, the party is surely aware of the likelihood of said incident and therefore should be capable of either mitigating against such an event or providing a price to address the risk of it occurring within

² <http://www.eleclink.co.uk/who-we-are.php>

their overall price (and thus allowing for a fair comparison to be made when assessing that overall price with other options).

Furthermore, SSE is concerned by the notion that developers could rely on contractors who use sub-optimal construction materials/solutions etc., while having a guarantee of, at the very least, the worst case revenue of the floor price especially where floor payments are allowed to continue until Ofgem makes a final determination on the qualification of an event.

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?

Variation 4 - Use project specific actual cost of debt and gearing to set the cap and floor levels, rather than the default notional cost of debt and gearing.

This variation would be better assessed on a project-by-project basis. SSE is unable to comment on the appropriateness of this method for either the Greenlink or NeuConnect projects as we are not in possession of all necessary information. However, we note that iBoxx is an appropriate comparator for a transmission asset whilst noting that interconnector projects have previously been compared to a single generation asset³ (which, of course, do not have the strong revenue certainty that an interconnector has via the cap and floor regime). Additionally, iBoxx is only available as an index based on certain project finance ratios therefore may not be appropriate for all interconnector projects.

Variation 5 – Maintain 25-year regime length

SSE disagrees with Ofgem's minded-to reject position on this variation. SSE would agree with Greenlink and NeuConnect that a 25 year regime length could lead to a better deal for GB customers. Offering developers certainty of returns over a longer period would in turn lead to a better deal for GB customers by reducing costs.

This variation could also offer a timely opportunity for Ofgem to consider the 25 year regime length, which at first glance appears to be a binary timeframe. Consideration must be given to how the asset is managed / funded / owned from the 26th year onwards. SSE is mindful of examples of interconnector assets, such as the IFA, which have lasted longer than 25 years. In such instances, where the asset remained operational beyond the 25 year default period under this Variation 5, is the expectation that the residual value of the interconnector asset would be transferred to GB consumers?

In-line with consideration at the Post Construction Review which considers whether costs have been incurred which are out with the control of the developer, a level of flexibility should be allowed in instances where the connection date is missed for similar reasons.

³ Drax, prior to its recent expansion from a single site operation.

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

SSE does not agree with Ofgem that the conclusion of the Poyry analysis completed in 2014 and 2017 should be assumed to continue to be broadly correct. The GB and wider EU electricity markets have undergone significant changes in this five year period. From the draft 2019 impact assessment published by Ofgem (itself based on the 2014 and 2017 analysis) key risk factors have not been considered. These include Brexit (with, for example, its associated impacts on cross-border trading⁴ across interconnectors that were not envisaged in Poyry's 2014 and 2017 work) and competition from other technologies to displace interconnectors. To ignore such significant changes over the last five years, to either of these risks is unacceptable. Given its priority is to protect the interests of existing and future energy GB consumers, it would be prudent for Ofgem to update the previous analysis to reflect changes that have occurred since 2014 and 2017 respectively.

⁴ See, for example, the Commission's statement of 27th April 2018:
https://ec.europa.eu/info/sites/info/files/notice_to_stakeholders_brexit_energy_market_final.pdf