



Making a positive difference
for energy consumers

Interconnector developers and
other interested stakeholders

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Dear stakeholders,

Open letter: Notification to interested stakeholders of our interconnector policy review

This letter is to notify interested stakeholders that we are reviewing our regulatory policy and approach to new electricity interconnectors. We invite interested stakeholders to get in touch to provide views on our proposed scope and to note their interest in contributing to this review.

Electricity interconnectors are the physical links that allow the transfer of electricity across borders. The cap and floor regime is the regulated route for electricity interconnector developers in Great Britain. We decided to roll out the cap and floor regulatory regime to new near-term electricity interconnectors in August 2014 to incentivise the delivery of further cross-border infrastructure.¹

We have held two application windows to date and have granted a cap and floor regime in principle to nine projects with a combined capacity of 10.9GW. If all of these projects go ahead, alongside existing interconnectors and approved projects under development on a merchant basis, GB interconnection capacity could increase to 15.9GW.

¹ Decision to roll out a cap and floor regime to near-term electricity interconnectors (2014): <https://www.ofgem.gov.uk/publications-and-updates/decision-roll-out-cap-and-floor-regime-near-term-electricity-interconnectors>

In our consultation on the initial project assessment (IPA) of cap and floor Window 2 projects in 2017², we stated that we expect to conduct a review of the need for, and timing of, any future cap and floor application windows. In our 2018 Window 1 update letter³ we noted that a review was necessary before opening any further cap and floor windows, and we reiterated that in our Forward Work Programme (FWP) consultation for 2020-22.⁴ We consider that now is the right time to undertake that review.

Background

Before the cap and floor regime was introduced, a limited number of electricity interconnectors had been either built or proposed: IFA (2GW) to France, Moyle (0.5GW) to Northern Ireland, BritNed (1GW) to the Netherlands, and the East West interconnector (0.5GW) to the Republic of Ireland. These interconnectors were mostly developed as standalone projects on a merchant basis.

We recognised that there was benefit in further interconnection and therefore a need to develop a regulated regime for electricity interconnectors to incentivise further development. We proposed a cap and floor regime initially for the Nemo Link interconnector (1GW) to Belgium⁵, and more broadly as an enduring regime.⁶

We have subsequently held two cap and floor application windows in 2014 and 2016, and have awarded a cap and floor regime in principle to nine interconnectors totalling 10.9GW in cross-border capacity. Nemo Link started operating in January 2019 as the first project regulated under the regime, bringing total GB interconnection capacity to 5GW at present.

Cap and floor regime summary

The cap and floor regime seeks to incentivise investment in new electricity interconnectors by striking a balance between commercial incentives and appropriate risk mitigation for project developers.

This is achieved by setting a minimum (floor) and maximum (cap) on the returns that an interconnector can earn, with a band of merchant exposure between. Where revenues fall

² Consultation on the IPA for cap and floor Window 2 projects: <https://www.ofgem.gov.uk/ofgem-publications/117521>

³ Cap and floor Window 1 update letter: https://www.ofgem.gov.uk/system/files/docs/2018/10/w1_fpa_update_letter.pdf

⁴ FWP 2020-22 consultation: https://www.ofgem.gov.uk/system/files/docs/2019/12/fwp_programme_2020_22_web.pdf

⁵ Cap and Floor Regime for Regulated Electricity Interconnector Investment for application to project NEMO (2013): <https://www.ofgem.gov.uk/publications-and-updates/cap-and-floor-regime-regulated-electricity-interconnector-investment-application-project-nemo>

⁶ Decision to roll out a cap and floor regime to near-term electricity interconnectors (2014): <https://www.ofgem.gov.uk/publications-and-updates/decision-roll-out-cap-and-floor-regime-near-term-electricity-interconnectors>

below the floor or rise above the cap, payments are made to or from the interconnector via the GB electricity system operator, National Grid ESO. The system operator then takes these payments into consideration when setting transmission charges.

The floor aims to provide long term revenue security for developers, subject to certain conditions being met, improving project financeability. The cap provides potential benefit to GB consumers through reduced energy bills, in return for their exposure in underwriting the floor.

The need for a policy review

We have committed to reviewing our regulatory policy and approach ahead of any further cap and floor application windows. This is to ensure that both further interconnection, and the regulatory framework for delivery, remain in consumers' best interests. We consider that now is the right time for this review for a number of reasons:

- There has been a global shift in ambition on decarbonisation, which will significantly alter the energy landscape. This means that the scenarios against which we test future interconnectors may be very different. We need to examine the role that interconnectors might play under these future energy scenarios.
- Additional cross-border capacity reduces price differentials between connected markets. This in turn reduces the revenues for, and socio-economic impact of, existing and future interconnectors that derive value from this differential. We observed this change between our Window 1 and Window 2 socio-economic modelling. As the baseline of operational interconnectors grows, we need to ensure that potential further interconnectors still add value.
- Market signals, including developer interest, suggest there is still a strong case for further interconnection. This is consistent with National Grid ESO's Network Options Assessment (NOA) for Interconnectors, which in 2019/20 suggested the optimal level of interconnection, from a GB welfare perspective, is between 18.1 and 23.1GW (which is above the current level of interconnector capacity with regulatory approval).
- There is increasing interest in multiple-purpose interconnectors (MPIs) from developers, governments and European transmission system operators. These are primarily projects which could link interconnectors with offshore renewable generation, and might form part of a potential North Seas grid. In particular, we note government's Offshore Transmission Network Review,⁷ in which MPIs will also

⁷ Offshore Transmission Network Review terms of reference:
<https://www.gov.uk/government/publications/offshore-transmission-network-review/offshore-transmission-network-review-terms-of-reference>

be considered. We therefore need to consider whether the conclusions of our 2015 Integrated Transmission Planning and Regulation (ITPR) project⁸ with respect to multiple-purpose projects are still fit for purpose, or whether further work is required.

- Through our cap and floor Window 1 and Window 2 consultations, we noted a number of industry concerns about the structure of the regime. Before committing to further application windows under the current structure, we want to continue to engage with, and consider the perspectives of, a diverse range of stakeholders.

Scope of the review

The primary objective of the interconnector policy review is to establish whether there is a need for further GB interconnection capacity beyond those projects currently with regulatory approval. If so, the secondary objective of this review is to consider Ofgem's approach to the regulation of future GB interconnection. We propose that the review will include, as a minimum, the following workstreams:

1. *Review of the cap and floor regime to date* – This workstream will look back at whether the objectives of the regime have been met, or will likely be met in the future. We will also consider the efficacy of the regime in meeting those objectives to identify whether there are changes or alternatives that might better deliver our objectives. This will include the regulatory design of the cap and floor regime and the structure of our current assessment framework.
2. *Socio-economic modelling* – We will be undertaking socio-economic modelling to determine whether further interconnection is likely in the interests of consumers. We will consider a range of future energy scenarios, and we expect to work with external consultants to deliver this workstream.
3. *Review of the wider impacts of interconnection* – We recognise that there are a number of wider impacts of increased interconnection. On the benefits side these can include providing flexibility, system operability services, and contributing towards decarbonisation. We also recognise that there may be additional system costs as a result of further interconnector capacity. We want to understand whether the way in which we assess projects needs to change to better reflect the full range of potential current and future impacts, particularly in the context of the UK's net zero commitment.

⁸ Ofgem's latest position on the regulation of multiple-purpose projects is set out in the final conclusions to the Integrated Transmission Planning and Regulation (ITPR) project in 2015: <https://www.ofgem.gov.uk/electricity/transmission-networks/integrated-transmission-planning-and-regulation>

4. *Multiple Purpose Interconnectors (MPIs)* – This workstream will review whether the final conclusions of our ITPR project on MPIs remain fit for purpose. We will also consider options for the regulation of MPIs and how this might interact with our regulatory approaches to point-to-point interconnectors. We will consider this alongside our ongoing work on offshore coordination with government and National Grid ESO.

We welcome comments from interested stakeholders on the proposed scope of the review as set out above.

Stakeholder feedback

We recognise the value of stakeholder engagement in the review process – we are keen to hear from interested parties. We request that stakeholders note their interest by 9 September 2020 by email to Cap.Floor@ofgem.gov.uk. We would be grateful if stakeholders could state which workstreams they wish to contribute towards, as this will help us to develop a targeted engagement approach.

If you have any questions in relation to this letter, please contact Andrew Bullimore by email (andrew.bullimore@ofgem.gov.uk).

Yours sincerely,



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