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3rd January 2017

Dear Sir/ Madam

Response to Public Consultation on the IFA2 Interconnector

On the 1st December 2016 the Commission De Regulation De L'Energie (CRE) published a consultation document on the IFA2 interconnector requesting interested parties to respond by 3rd January 2017.

This letter sets out the response to the consultation by GridLink Interconnector Ltd ("GridLink"). GridLink is a proposed new 1.4GW HVDC/ VSC interconnector between France and the United Kingdom. The project has a capital cost of approximately €950m and when operational in October 2022 will deliver sufficient electricity to supply approximately 2m households. The project will bring significant economic benefits to consumers in both France and the United Kingdom and make a material contribution towards reducing carbon emissions, delivering a net reduction in the level of CO₂ emissions of 2.8 million tonnes in its first year of operation and an average reduction of 1.6 million tonnes per year in each of the following 25 years.

GridLink was granted an Interconnector Licence in December 2016, and has submitted an application for a Cap and Floor scheme to the UK regulator Ofgem (Office of Gas and Electricity Markets). GridLink is included in the 2016 ENTSO-E Ten year network Development Plan and has also recently applied to the European Commission for status as a Project of Common Interest.

This response is not confidential and may be published by CRE.

1. Do you have any remark on the level of the expected capital expenditures for the project?

The consultation paper states the capital cost of the IFA2 project is approximately €740m (2017). Unfortunately the paper does not provide a breakdown of what items are included or excluded in this cost estimate, nor does the paper contain a sufficiently detailed description of the project in order to estimate what these costs may be.

By way of example the paper states the cable length to be approximately 200km, in fact this figure only refers to the length of the offshore section of the cable and does not include the length of the onshore cable which is approximately 32km (28km in France and 4km in the UK). The additional 32km of onshore cable represents a capital cost of at least €45 million and the paper does not state whether this amount is included or excluded in the capital cost estimate.

There are other costs in addition to the cost of plant and equipment, which are significant and which contribute to the total cost of the project. These costs include, but are not limited to, financing costs, development costs, tendering costs, construction management costs and land acquisition costs. The consultation paper is silent on what these costs are and whether they are included or excluded in the capital cost estimate.

In the absence of this information it is not possible to provide constructive comment on the cost estimate presented, nor is it possible to provide comment on the total cost of the project which we believe is actually the more relevant figure to consider in the cost benefit analysis.

We recommend CRE issues a supplementary document to the consultation paper which provides this additional information.

2. Do you agree with CRE's assessment regarding operation and maintenance costs?

The consultation paper states that the annual operating and maintenance (O&M) costs for the IFA2 project are estimated to be €9.6m/year. The paper does not however state whether this figure represents total O&M costs for the entire project or whether it represents only RTE's 50% share of the total O&M costs. Moreover the paper does not provide a breakdown of what costs are included or excluded in this estimate or how these costs were estimated. By way of example the paper does not state whether the estimates include decommissioning costs, market related operating costs (imbalance charges), depreciation or insurance costs.

Replacement costs:

The consultation paper asks whether respondents agree with CRE's position that equipment replacement costs should be included in IFA2's allowed budget for annual operating costs.

We agree with CRE that where replacement of plant and equipment is justified, replacement costs should be included in the operating cost budget. We also agree with CRE that allowed replacement costs should be spread over the expected lifetime of the project and further agree with CRE that the design / operating life of the project can reasonably be expected to be approximately 40 years.

The consultation paper is however silent on whether the magnitude of replacement costs are reasonable. Whilst the paper does state that replacement costs represent approximately 50% of the annual operating budget, the paper does not actually identify what items of plant and equipment are to be replaced or what the replacement cost for those items of equipment are estimated to be.

As replacement costs represent a material proportion of the annual operating costs, we would expect to see a list of the items of equipment which are to be replaced and to see a reasoned justification for their replacement.

Decommissioning Costs

The consultation paper is silent on whether an allowance has been made for decommissioning in the operating cost budget.

We believe it would be beneficial if the paper indicated what assets are to be decommissioned, what the estimated costs of decommissioning costs those assets are and how the value of equipment spares are treated at decommissioning. It would also be beneficial to see details of the decommissioning program and a justification for the program based on legal requirements as well as environmental, health and safety considerations.

In order for respondents to provide constructive comment on operating and maintenance costs, we respectfully request CRE issue a supplementary document to the consultation which provides the additional information described above.

3. Do you agree with CRE's assessment of the cost of the power losses due to the interconnector IFA 2?

The context in which CRE refers to power losses is in regard to system wide losses at the European level arising from the presence of the IFA2 interconnector. These losses are in turn deducted from the European wide system benefits to derive a net benefit figure upon which RTE receives a bonus.

CRE state that ENTSO-E (the European Network of Transmission System Operators - Electricity) are unable to provide data on system wide losses at this point in time, and that the methodology for deriving this information is not understood. As a result, and as a substitute for using data provided by ENTSO-E, CRE propose using line losses estimated by RTE which relate solely to the IFA2 project.

Under article EC 838/2010 ENTSO-E is mandated to publish an annual report on European wide transmission losses the "ITC Transit Losses Data Report"¹. The report calculates losses before and after flows of electricity from particular projects so that losses are attributable for the purposes of determining compensation payments between system operators. The methodology used by ENTSO-E to calculate the losses is also published in the report.

We would agree with CRE that to the extent information is unavailable from ENTSO-E on European wide losses, CRE only consider losses at the level of the UK and French transmission system networks. We believe that the transmission system operators in France and the UK are in the best position to provide this level of information. The paper is however silent on whether the respective French and UK system operators have been requested to provide this information. Indeed the paper is silent on the source of information provided on losses and how they were derived. To the extent that the transmission system operators are unable to provide data on system losses in the timescale required by CRE we believe it would be pragmatic for CRE to consider line losses relating only the IFA2 project in France and the UK.

The magnitude of transmission system losses cited in the consultation paper is quoted in Euros. In order to make it possible to comment on whether or not this figure is a reasonable

¹<https://www.entsoe.eu/publications/market-reports/itc-transit-losses/Pages/default.aspx>

estimate, the paper should quote the losses in MWh and identify the electricity price at which the conversion from MWh to Euros is made. In addition the paper should cite the losses in France and UK separately. It should also separately identify losses incurred in the interconnector (line losses and converter losses) and losses incurred on the connected transmission system. The consultation paper does not provide this information.

We are also of the view that it would be inappropriate to consider transmission losses without also considering the corresponding costs or benefits realised by the respective transmission system operators in managing congestion arising from the presence of the interconnector.

Depending on the where an interconnector connects into a transmission system and the level of constraints already present in the system, an interconnector may cause or relieve constraints in the transmission system. To the extent that the presence of an interconnector relieves system constraints, this will have benefits to the system operator in terms of reducing the costs of managing congestion and which are ultimately passed on to consumers. These costs or benefits may be significant and far larger than transmission losses. The consultation paper is silent on whether congestion costs or benefits are taken into account.

We recommend that in addition to transmission losses CRE also takes into account congestion costs/ benefits incurred by the transmission system operators arising from the presence of the IFA2 interconnector.

This information is readily available for the IFA2 project in the UK as part of the process for determining the most cost effective connection point includes a cost benefit analysis by the transmission system owner which identifies congestion costs/ benefits. As the IFA2 project has executed a grid connection agreement this information will be available.

Revenues from the Capacity Mechanism

In assessing revenue streams generated by the IFA2 project we note that CRE have specifically excluded income earned from IFA2's participation in the capacity market on the grounds that RTE have not provided sufficient information on how these revenues were calculated.

Interconnectors have been permitted to participate in the UK capacity market since 2015, and in November 2016 the European Commission confirmed that interconnectors were eligible to participate in the French Capacity mechanism². Consequently we believe that it is appropriate to include anticipated revenues from the capacity market in IFA2's revenue projections.

It follows that the developer should provide a reasonable basis for forecasting what these revenues may be and to agree this methodology with the respective market Regulator, in this case CRE.

We are not in a position to comment on whether the methodology proposed by RTE is reasonable or not as details of the methodology have not been included in the consultation paper. We would recommend CRE issues an addendum to the consultation paper setting out the proposed methodology so that respondents may comment on it.

²http://europa.eu/rapid/press-release_IP-16-3620_en.htm

4. Do you agree with CRE's assessment regarding the cross-border reference capacities in 2020 and 2030 ?

We believe CRE's assessment of cross border reference capacities is incomplete and should include reference to the interconnector projects contained in the following official publications (i) ENTSO-E's 2016 Ten Year Network Development Plan (ii) RTE's Bilan Previsionel 2016 and (iii) the interconnector Transmission Entry Capacity (TEC) Register published by the UK transmission system operator.

CRE's assessment does not currently include all the interconnector projects listed in these official sources and therefore we believe CRE's assessment of cross border capacities is incomplete.

Table 1 below is an extract from a Cost Benefit Analysis report prepared by Baringa Partners as part of GridLink's application to Ofgem for a Cap & Floor scheme (dated October 2016). The table lists the interconnector projects extracted from these official sources and which we believe should be also considered by CRE when assessing cross border reference capacities. Based on this cost benefit analysis the table also indicates the year in which it is considered economically viable for a project to proceed under each of market scenarios modelled.

Table 1. Existing and Proposed Interconnector Projects linked to the UK

Interconnector	Connecting country	Commissioning year			GB import capacity (MW)
		Reference	High Commodities	Low Commodities	
IFA	France	Existing	Existing	Existing	2000
Moyle	Northern Ireland	Existing	Existing	Existing	280
	Republic of Ireland				
EastWest	Ireland	Existing	Existing	Existing	500
BritNed	Netherlands	Existing	Existing	Existing	1000
ElecLink	France	2019	2019	2019	1000
NEMO	Belgium	2019	2019	2019	1000
FABLink	France	2022	2022	2022	1400
NSN	Norway	2023	2023	2023	1400
Greenlink	Republic of Ireland	2025	2025	2025	500
IceLink	Iceland	-	2027	-	1000
Viking	Denmark	2025	2025	-	1400
IFA2	France	2021	2021	2021	1000
North Connect	Norway	-	2022	-	1400
Acquind	France	-	2022	-	2000
Gridlink	France	2022	2022	2022	1400

We recommend that the projects listed in the latest ENTSO-E TYNDP, RTE's Bilan Previsionel and National Grid's TEC Register are taken into account in CRE's assessment of cross border reference capacities. The cost benefit analysis should also assess whether it is economically viable for a project to proceed under a particular scenario, and if so when, and this will define the cross border interconnector capacity that is available in any particular year or scenario.

5. Do you agree with CRE's assessment that the current European Union (including the United Kingdom) as a whole derives a positive net benefit from the IFA2 project?

Yes, we agree with CRE's view that the development of new interconnector projects do provide positive net benefits to the European Union. Whilst the magnitude of benefits which may be realised will differ between forecasts, the consensus of opinion is that further electrical interconnection capacity between member states of the European Union is beneficial and have been widely reported^{3,4,5,6,7,8,9}.

Most recently the European Commission itself on 21st December 2016 issued its "2017 Call for Projects" specifically identifies interconnection between UK and France as a Priority Corridor and invites interconnector developers to apply for status as a Project of Common Interest and access grant funding under the Connecting Europe Facility^{10,11}.

The European Commission clearly views further interconnection between the UK and France as a priority despite the uncertainties arising from the Brexit referendum. The IFA2 project was granted status as a Project of Common interest in November 2015¹².

6. Do you agree with CRE's assessment of the economic benefits derived from the project, given the results of the British referendum ?

The economic benefits of interconnection are dependent on a number of factors and not just the result of the Brexit referendum. Other factors such as electricity supply and demand, oil price and governmental policy on emission targets play a crucial role in determining the price differentials which drive European electricity markets, and these fundamentals have not changed as a result of the referendum.

³ More Interconnection: Improving energy security and lowering bills. Department of Energy & Climate Change. December 2013.

⁴ Getting Interconnected: How can interconnectors compete to help lower bills and cut carbon. Policy Exchange. 2014.

⁵ Cost and Benefits of GB interconnection. A Poyry report to the National Infrastructure Commission. February 2016.

⁶ Benefits of Interconnectors to GB Transmission System. National Grid. December 2014.

⁷ The benefits of integrating European electricity markets. Energy Policy Research Group. January 2016.

⁸ Benefits of an integrated European Energy Market. Booz & Co for Director General of the European Energy Commission. July 2013

⁹ Renewable Energy Integration in power grids. International Renewable Energy Agency. April 2015.

¹⁰ <https://ec.europa.eu/energy/en/news/call-opens-new-projects-common-interest>

¹¹ Needs in the NSI West Electricity Corridor that can be addressed by infrastructure (final). Regional Groups for electricity meeting 13.12.2016

¹² https://ec.europa.eu/energy/sites/ener/files/documents/5_2%20PCI%20annex.pdf

The economic benefits of interconnection can be modelled and measured against several different socio-economic factors. The benefits documented by ENTSO-E in their guide to cost benefit analysis of Grid Development Projects include:

- Lower wholesale electricity prices
- Reduced carbon emissions
- Enhanced security of supply
- Better integration of renewable energy sources

The magnitude of benefits will vary from model to model and depend on the assumptions used in making the forecast as well as the forecasting methodology itself. The methodology employed by CRE in estimating the benefits of the IFA2 interconnector are not set out in the consultation paper, nor does the paper set out key assumptions on market parameters such as oil price, inflation, Gross Domestic Product or exchange rates.

In October 2016 and as part of its application to Ofgem for a Cap and Floor scheme Gridlink appointed Baringa Partners to undertake an independent cost benefit analysis of the GridLink project¹³. The analysis takes account all of the interconnector projects listed in the TYNDP, RTE's Bilan Previsionel and National Grid's TEC Register and assesses the socio-economic benefits of the project under a range of possible market scenarios.

As the study is recent (October 2016) and undertaken following the Brexit referendum, the analysis also takes into account the potential economic impacts of the referendum. The results of this analysis are summarised in Table 2 below.

The results clearly show that the GridLink project will bring significant positive socio-economic benefits both to the UK and France in all of the market scenarios considered. In the base case, GridLink delivers a net positive social welfare to consumers in France and the UK of €1.3bn over the 25 year assessment period. In its first year of operation GridLink is expected to reduce carbon emissions by 2.8 million tonnes and over the 25 year assessment period reduce emissions by an average of 1.6 million tonnes per year.

Table 2. Summary of social welfare analysis for the GridLink interconnector

€m NPV*		Reference case	High Commodities	Low Commodities
GB	Net producer welfare	(3,992)	(3,600)	(4,068)
	Net consumer welfare	4,481	4,484	4,075
	Net interconnector welfare	(405)	(715)	(226)
	Net social welfare	84	169	(219)
France	Net producer welfare	7,369	6,236	3,362
	Net consumer welfare	(5,248)	(4,174)	(2,762)
	Net interconnector welfare	(834)	(1,168)	(315)
	Net social welfare	1,287	894	284
Total	Net producer welfare	3,377	2,636	(706)
	Net consumer welfare	(767)	310	1,312
	Net interconnector welfare	(1,239)	(1,883)	(541)
	Net social welfare	1,371	1,064	66

*Real 2016; NPV using 3.5% discount rate; period 2022-2046

¹³ Cost Benefit Analysis of the GridLink project submitted to Ofgem in October 2016 as part of GridLink's application for a Cap and Floor scheme.

Although this cost benefit analysis was specifically undertaken for the GridLink project, the analysis assumes the IFA2 project will become operational in 2021 and the GridLink project will become operational one year later in 2022. Consequently we would expect to see a similar set of positive socio-economic benefits for the IFA2 project (it should be noted that the GridLink project is 1.4GW whilst IFA2 is 1GW and therefore the benefits from GridLink will be proportionately larger).

Similarly, whilst the cost benefit analysis is specifically focused on the UK and France we would expect to see a similar positive net benefit when considering a wider European context.

A copy of the Cost Benefit Analysis report for GridLink project will be forwarded to CRE under separate cover. Details of the methodology employed and key assumptions are set out in the report.

In addition to bringing about a reduction in emissions of CO₂ and lower wholesale electricity prices there are a broad range of network and societal benefits that new interconnectors such as GridLink and IFA2 can bring and which Baringa did not attempt to quantify in their cost benefit analysis (so called “hard to monetise” benefits). The section below provides a brief qualitative overview of these hard to monetise benefits.

Security of supply – interconnectors can make a positive contribution toward enhancing security of supply by increasing diversity both in terms of available sources of energy and supply routes thus increasing system resilience and reliability. Interconnectors also have higher physical availability than generation assets due to the inherent reliability of the technology and the lack of moving parts. New interconnectors between the UK and France will lead to an increase in the volumes traded on wholesale electricity markets thus to contribute positively to the overall level of market liquidity.

Improved System Flexibility – Interconnectors are capable of providing a range of ancillary services to the transmission system operators of the countries which they connect. Interconnectors are also uniquely positioned to absorb surplus energy in one grid and transport it to another which is in need of energy. The direction of electricity flow can be switched at very short notice and at extremely fast ramp rates thus providing system operators with additional tools and flexibility to balance electricity flows over the networks they manage. Other benefits include:

- provision of black start capability
- fast frequency response
- provision of voltage control services (separate control of active and reactive power)
- facilitation of cross border trade in ancillary services, and
- facilitation of emergency assistance to/from neighbouring countries.

Better Integration of renewables - as the penetration of renewables increases (most of the recent capacity growth in France has come from renewable energy), so too does the likelihood of periods when there is an excess of intermittent generation over demand and the prospect of energy curtailment. Additional interconnection between France and the UK provides the ability to export the excess power in such periods. Thus interconnection provides positive support for renewable projects already in operation as well as support for the further development of new renewable projects. As such it is likely to be easier and less costly to achieve target levels of renewables capacity if more interconnection between neighbouring countries is developed.

Deferred investment in generation– It is likely that the development of interconnectors will lead to deferred or avoided investment in new power stations. This would have an additional benefit to the economies of the UK and France. The cost benefit analysis undertaken by

Baringa for GridLink does not take into account this benefit and this is consistent with CRE's approach.

7. Do you agree with CRE's assessment that the result of the British referendum raises new risks for the project IFA 2?

The economic benefits of interconnection are dependent on a number of factors and not just the result of the Brexit referendum. Other factors such as electricity supply and demand, the price of oil and governmental policy on emissions all play a crucial role in determining the price differentials which drive the electricity markets in Europe. These fundamentals have not changed as a result of the referendum. We do not expect to see material changes in Network Codes, government policy on emissions reduction or changes in aspects of competition law such as third party access which would affect the development of interconnectors. Nor do we see physical decoupling of the electricity markets.

There is however uncertainty regarding the nature of future trading arrangements between the UK and other European countries following a Brexit, and depending on the outcome of negotiations on those arrangements, trade volumes may be impacted and this will affect exchange rates. This uncertainty over future trading arrangements has already been factored in by foreign exchange markets as is reflected in and evidenced by, the depreciation of sterling following the referendum.

The cost benefit analysis undertaken by Baringa Partners and summarised in Table 2, takes into account the fall in £/€ exchange rate and despite the depreciation of sterling concludes that the economic case for more interconnection between the UK and France remains strong and is unchanged following the referendum.

In relation to the specific points raised by CRE:

Network Codes - the network codes which govern access, operation and usage of the electricity transmission systems in the UK, France and other European countries have been in place for many years and are fully aligned to provide a stable platform for cross border transfers of electricity in addition to third party access and usage of domestic transmission and distribution systems. The UK is a party to the European institutions which govern the development of network codes such as ENTSO-E and ACER (Agency for the Cooperation of Energy Regulators), and following an exit from the European Union the UK would need to define a new relationship with these bodies. Given the level of standardisation and integration which already exists within the European electricity combined with the fact that network codes relate largely to technical matters, we do not see significant changes being made to network codes as a result of the Brexit referendum.

Competition Law and Third Party Access - In terms of the continued application of European competition law post Brexit we do not expect any significant changes to existing legislation relating to key policy areas such as third party access, unbundling, use of revenues or capacity auctions. Indeed the UK has championed much of the European legislation relating to competition and third party access due to the significant benefits that competition brings to consumers. Consequently we see no significant changes in aspects of competition law that would impact the energy sector or interconnector development. Moreover interconnector developers can unilaterally undertake to voluntarily adopt and comply with the laws or network codes of other countries to which they connect even though such obligations

may not be mandatory in a domestic setting. To the extent that such departures did arise we would expect developers to voluntarily comply with European legislation.

Contractual uncertainty – Articles L.111-40, L.321-1 and L.321-6 of the French Energy Code stipulate that only RTE may own and operate an interconnector on French territory, and a third party may only do so if they seek and obtain an exemption. A consequence of this legislation is that any joint venture between RTE and another party must be dissolved and ownership split when the interconnector becomes operational.

No exemption from this legislation is being sought in the case of the IFA2 project. The contractual arrangements described by CRE in the consultation state that the joint venture formed between RTE and NGIH (National Grid Interconnector Holdings) will be dissolved at commercial operations. Indeed this structure follows the recent example set by the Inelfe interconnector between France and Spain, which is jointly owned by RTE and the Spanish Transmission System Operator REE, where the joint venture was dissolved and ownership of the interconnector split between the parties immediately following commercial operation. As such the contractual arrangements described by CRE regarding the split of ownership in the IFA2 project after commercial operation appear to be in line with and satisfy the requirements of the French Electricity Code.

In terms of the contractual arrangement between RTE and NGIH relating to the operation of the interconnector after the split of ownership (the Operating Agreement), CRE does not provide any details of what is contained in this agreement. As such CRE is requesting comments to be made on a document without providing details of what the document actually contains. As this description is absent it is not possible for respondents to provide comment on its content.

Our expectation is that the operating agreement will relate principally to technical and commercial matters such as nomination procedures and liability in the event the interconnector becomes unavailable. As such, and to the extent our assumption is correct we do not see that referendum would have any impact on the agreement.

Exchange Rates - Foreign trade plays a crucial role in the economies of the UK, France and other European countries. In 2015 the volume of goods and services exported from the UK to other members of the European Union accounted for approximately 44% (£220bn) of all exports from the UK¹⁴, whilst exports from EU members to the UK accounted for approximately 55% of total exports from the European Union.

The nature of future trading arrangements between the UK and Europe following the Brexit referendum are unclear. In particular the terms and conditions on which the UK may access the internal market and whether such access would continue to remain on a tariff free basis. Similarly the terms on which members of the European Union might access the UK market are equally unclear at this point in time.

It is however clear that if no agreement is reached, then as both the UK and the European Union are independent members of the World Trade Organisation (WTO), the WTO tariffs on goods and services would otherwise be applicable. Under the agreed (bound) WTO tariff schedules there are no import tariffs on electricity. It is zero rated. Similarly whilst there are quotas for other goods and services there are no quotas for electricity. The WTO rules have focussed on import tariffs rather than export tariffs because countries normally want to export their goods and not make them uncompetitive by placing an export tariff on them. We therefore believe it is reasonable to expect that no import or export tariffs on electricity will be

¹⁴ UK Office of National Statistics

applied. Tariffs are however payable on a variety of other goods and services, and as electricity represents only a small portion of total trade volumes between the UK and the rest of Europe, if no agreement is reached on access to the internal market and WTO rules are applied we would expect to see the WTO tariffs being applied across a range of goods and services resulting in changes to the balance of trade. Given the volume of trade that takes place between the UK and other members of the European community any changes in the balance of trade will affect exchange rates.

Indeed the foreign exchange markets have already reacted to the result of the referendum. In 2015 the average £/€ exchange rate was 1.37 and immediately following the referendum the pound fell to 1.16, representing a 15% decline in the value of sterling and it has broadly remained at this level since the referendum currently trading at 1.18¹⁵. Consequently it is clear that foreign exchange markets have already factored in uncertainty over future trading arrangements and this is reflected in the lower value of the pound.

Given our view is that Brexit does not change fundamentals such as supply and demand which drive the electricity markets in Europe, that we do not anticipate any legislative changes concerning competition law nor do we see governments signalling any change in policy on emissions, we believe the potential impacts of the Brexit referendum are best represented by movements in exchange rates rather than by any other measure.

The cost benefit analysis undertaken by Baringa (summarised in Table 2) which takes into account the depreciation of sterling following the referendum, clearly show the economic benefits to consumers in France and the UK remain strong despite the results of the referendum. Consequently we believe the economic case for additional interconnection between the UK and France is compelling and is unchanged following the Brexit referendum.

8. Do you have any comments regarding the above description of the risk sharing rules contemplated by RTE and NG IFA2 Ltd, following the result of the British referendum?

The new arrangements proposed by CRE relate to the bonus payments made to RTE under CRE's incentive scheme. The proposals differ from those previously set out in the TURPE5 regulatory framework which were approved by CRE on 17th November 2016. CRE are seeking views on whether these changes are justified following the Brexit referendum.

Under the previous arrangements RTE were allowed to earn a performance related bonus which was based on factors that were entirely within its control such as availability, meeting and not exceeding capital cost estimates and staying within its budgeted annual operating costs. Under the new arrangements however RTE's bonus is dependent upon market related factors which are entirely outside of RTE's control.

We believe that making the entirety of RTE's bonus payments subject to factors which are outside of its reasonable control is counter productive and does not act as an incentive for RTE to develop interconnectors or to operate those it does develop in the most cost effective manner.

In addition because Brexit has not actually happened yet, we are of the view that to the extent changes in the regulatory regime are imposed specifically in anticipation of the outcome of

¹⁵<http://www.x-rates.com/>

Brexit those changes should also be capable of being reversed if those assumptions do not materialise.

Moreover the bonus scheme proposed by CRE does not also appear to provide with the necessary tools which would allow it to respond to changes in the market place and recover from a downturn in market conditions.

Specifically, bonus payments are subject to meeting targets for the physical flows of electricity rather than on meeting targets on revenue generated. By way of example, in response to a market downturn RTE might offer additional services to the market such as black start or frequency response. Such services would allow RTE to generate additional revenues but would not necessarily increase the physical flow of electricity. Under the proposed bonus scheme however RTE would still be penalised because the bonus is based on throughput rather than revenue. Similarly RTE could respond to a downturn in the market by reducing price. This would have the effect of increasing throughput without necessarily increasing revenue, and under the proposed scheme RTE would still receive a bonus even though it was generating a lower income.

Conceivably a price reduction could also be as a result of predatory pricing, and as the operator would be paid a bonus because of higher throughputs, the proposed regulatory framework scheme would actually be encouraging and rewarding predatory pricing and anti-competitive practices

Given these observations we are of the view that the bonus scheme should be based on revenue targets rather than throughput targets.

We also note that under the new proposals RTE's bonus is based on a $WACC \pm X\%$ formula. As WACC is fixed for each regulatory control period and the bonus payment is calculated over a number of different regulatory control periods, the bonus will change as WACC changes. Perversely the lower the cost of capital achieved by RTE the lower its bonus becomes. We believe it is far better to fix a cap and a floor at the outset and for the entire duration of the bonus assessment period.

The counter argument for making bonus payments subject to market conditions is that RTE should not receive a bonus for building an interconnector, no matter how efficient or cost effective it may be, if there is actually no market for the service it provides. Given that RTE is entirely at liberty to choose the number of projects it seeks to develop, making bonus payments subject to market conditions also ensures the interest of consumers and RTE are aligned by incentivising RTE only to develop the most cost effective projects.

On balance therefore we believe it is appropriate that RTE should bear some level of market risk and suggest that a proportion of its bonus payments is market related and a proportion is performance related. We would suggest 30% is market related and 70% is performance related. We believe RTE should bear some level of market risk, and this also has the benefit of avoiding the possibility of CRE having to unwind changes to the regulatory regime if the assumptions it has made regarding Brexit are not realised.

Under the previous TURPE regime the penalties applicable if RTE failed to achieve its targets were confined to a repayment of, or a reduction in the bonus payments it receives, and the total value of penalties did not exceed the total value of bonuses which were paid or due. It is unclear whether or not this remains the case under the current proposals.

If penalties extended beyond bonus payments this could in some circumstances lead to IFA2 having to raise additional finance in order to its fund operating costs, because the revenues it had generated from sales were used to pay penalties. We do not believe CRE should impose a regulatory regime where IFA2 would not be able to finance the cost of its operations. This is

particularly the case where penalties arise due to reasons entirely beyond the reasonable control of IFA2. We recommend that to the extent that penalties are imposed these are limited to and do not extend beyond a repayment of or a reduction in bonus payments.

9. *Given the uncertainties regarding the consequences of the British referendum, do you think the business-as-usual regulation framework of the TURPE should apply, or do you consider on the contrary that a strengthened incentive regulation framework should be used to share risks between RTE and users?*

The economic benefits of interconnection are dependent on a number of factors and not just the result of the Brexit referendum. The fundamental factors which drive price differentials in European markets such as the level of electricity supply and demand, oil price, government policy on competition and third party access or policy on CO₂ emissions reduction have not changed as a result of the referendum.

We do believe the potential effects of Brexit are best represented and accounted for by movements in the £/€ exchange rate. The depreciation of sterling immediately following the referendum is evidence of this and indicates that markets have factored in uncertainty in future trading arrangements following the Brexit referendum.

To the extent that the cost benefit analysis for IFA2 or any other interconnector takes into account this depreciation and still show net positive economic benefits we believe its development should be supported.

We do not see a need or justification to introduce changes to the regulatory regime specifically to account for the potential impacts of Brexit, however we do feel it is appropriate for RTE to bear some level of market risk and as such we would advocate that a proportion of its bonus scheme is linked to market prices as described in the response to Question 8 above.

One advantage of this approach is that there will then be no need to unwind changes to the regulatory regime specifically made to account for Brexit if the assumptions made specifically for Brexit do not subsequently materialise.

Consequently and with the exception of making a proportion of RTE's bonus scheme subject to market risk, we would advocate a continued business-as-usual approach to the regulatory framework.

10. *If you are in favour of a strengthened regulatory framework for the interconnector IFA 2, do you find the structure of the envisioned incentive regulation mechanism relevant?*

We consider that a strengthened incentive regulatory framework should be used to share risks between RTE and consumers, and that such a regime can be mutually beneficial by aligning the interests of consumers and investors through a better management of project risks. We believe a cap and floor approach achieves this objective though we have specific concerns about certain aspects of the proposals made by CRE (outlined above) which would appear to act as a disincentive to efficient operation.

In particular we note three important, and we think potentially counter-productive features of the proposed incentive mechanism:

1. RTE as the owner/ operator of a regulated interconnector should be incentivised to efficiently manage its capital and operating costs. The regime as proposed penalises RTE for events beyond its control and removes that incentive. A more balanced framework in which RTE bonuses are not solely dependent on market forces is more appropriate.
2. Under the proposed regime bonus payments are subject to throughput targets being achieved as opposed to revenue targets being achieved. This will act as a disincentive to innovation and will discourage RTE to provide ancillary services as the effect of providing these services would be to increase revenue and not throughput. Price reductions in interconnector transportation tariffs can be expected to lead to lower revenues but higher throughput, as such a bonus scheme based on throughput rather than revenues may potentially act to actually encourage and reward anti-competitive pricing policies
3. The proposed regulatory assessment period over which bonuses are calculated is ten years. However the design / operating life of the asset is 40 years, as such bonuses may be paid out early thus removing the incentive for RTE to perform efficiently after the initial ten years. A mechanism which incentivises RTE on an annual basis and over the entire lifetime of the project rather than only the first ten years is more appropriate and better represents a better allocation and sharing of risks and rewards between investors and consumers.

11. Do you find the level of the different scenarios appropriate? Which one do you favour?

We favour a cap and floor approach whereby capacity is sold by way of auction and floor prices are set at a level which allows RTE to recover capital costs, operating costs and a regulated rate of return. To the extent that clearing price exceeds the floor price RTE would benefit up to a threshold cap, beyond which benefits are returned to consumers by way of a reduction in transmission charges. This has the benefit that the level of incentive payments is set by market demand; that availability (performance) risk is solely borne by the operator and that market risks and rewards are equitably shared between investors and consumers.

This framework shares similarities with the regulatory framework of other interconnectors which operate under a regulated and merchant framework and has the additional benefit of having a single aligned regulatory framework governing the operation of interconnectors.

We thank CRE for the opportunity to respond to the consultation and hope our comments have been both constructive and useful. We believe there is a compelling economic case for more interconnection between France and the UK and that further interconnection will bring the following key benefits:

- Lower wholesale prices of electricity
- Reduced CO2 emissions
- Enhanced security of supply
- Better integration of renewable energy sources
- Improved system flexibility
- Enhanced market liquidity and cross border trading , and
- Lower congestion management costs

Should CRE have any queries on our response or wish to discuss any aspects of this response in more detail please do not hesitate to contact us.

Yours sincerely

[Signature provided on original]

GridLink Interconnector Ltd