

Ofgem's interconnector policy review

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Introduction

In June, Ofgem published initial proposals on its Interconnector Policy Review (IPR)¹. Ofgem's analysis shows that further interconnection would deliver socio-economic welfare benefits and Ofgem is now developing proposals for adjustments to the future design of the interconnector cap and floor (C&F) regime.

Work on the C&F design is taking place in parallel with several other relevant policy workstreams under which Ofgem is attempting to balance several objectives for future electricity infrastructure development.

Across these policy areas, Ofgem's focus on supporting future electricity system coordination is understandable given the significant development of the GB electricity network that is expected in the next decade and beyond. However, other relevant factors are also important to consider - in particular, the impacts that any changes to the regime may have on the allocation of risk between project developers and consumers.

CEPA has been involved in the design and development of the C&F regulatory regime since its inception. From our review of Ofgem's proposals, we identify a risk that Ofgem's focus on enhanced coordination within the C&F regime could dilute the 'developer led' principles that have been fundamental to the regime to date. Proposed changes could shift interconnector development risk away from project developers and onto consumers.

In the case of multi-purpose interconnectors (MPIs), we believe that this trade-off may be necessary as MPIs begin to form a part of an increasingly meshed offshore network. However, for the development of point-to-point (P2P) interconnection, it is less clear that the benefits of proposals to enhance coordination will outweigh the potential impacts on investment resulting from the dilution of 'developer led' principles.

The successes of the 'developer led' regime

Ofgem's review of the operation of the cap and floor regime to date rightly highlights the success of the developer-led regime under which "*developers were responsible for the location, size and timing of their investment following market price signals.*"² The 'developer led' nature of the C&F regime has delivered a range of benefits. While some commercial protection is provided by the floor, interconnectors remain exposed to commercial signals and risks in the wholesale, capacity, balancing and ancillary markets.

The approach introduces market-based signals into interconnection development decisions, placing the majority of investment risk regarding sizing, location and country of connection on project developers and thus, incentivising efficient decision making. The 'developer led' approach helps to attract alternative financing solutions and promotes innovative routes to market for new projects.

Proposals for enhanced coordination

While acknowledging these principles, a common theme in Ofgem's proposals for the future of the C&F is the more significant role envisaged for National Grid Electricity System Operator (NGESO). This includes an enhanced role in future assessment of C&F applications and, under Ofgem's preferred model for C&F application windows, would also include determining '*where, when and how much interconnection is needed*'.

¹ See [here](#)

² See [here](#)

Discussion of enhanced coordination aligns with an emerging theme in the development of new network infrastructure. The emergence of NGENO's Network Options Assessment (NOA)³ introduced a more significant coordination role for onshore assets.

Ofgem and BEIS are consulting on greater coordination of new offshore assets under the Offshore Transmission Network Review (OTNR)⁴. These proposals are at an early stage and the development of models for offshore coordination will take some time to finalise and implement.

Both onshore and offshore transmission assets are characterised by the need to consider efficient network development through anticipatory investment. Offshore network development may also be increasingly characterised by a need for sharing of offshore transmission assets between developers. MPIs share similar anticipatory investment and shared asset requirements⁵. These projects are expected to become increasingly complex and form part of an emerging offshore network.

The risks with 're-centralising' P2P interconnector development

Ofgem and BEIS's desire for greater coordination across integrated onshore, offshore and MPI assets is understandable in the context of the expected development of the GB electricity network. However, there is a risk that a general trend for enhanced coordination is mapped onto P2P interconnector development without due consideration of the specific costs and benefits.

P2P interconnectors and MPIs are distinct classes of asset and regulatory policy should seek to reflect their specific characteristics and requirements. The merits of enhanced coordination for P2P interconnection⁶ are less apparent than for MPIs. Most importantly, unlike MPIs and offshore network assets, P2P interconnection does not require consideration of shared assets or of the risks (and associated societal benefits) from anticipatory investment⁷.

While MPIs are unlikely to be completed before 2030, regulatory certainty is needed for the development of P2P interconnectors in the meantime to ensure that the existing pipeline of projects can be completed.

Ofgem's proposals for an enhanced role for NGENO could risk 're-centralising' P2P interconnector development and diluting the regime's 'developer led' principles that have guided recent investment. Under the proposed model for C&F application window design, key decisions regarding new interconnection ('location, size and timing') would result from NGENO analysis and decision-making processes rather than being driven by market signals.

This centralisation of interconnector decision making risks restricting the flexibility for the development of new interconnector projects. It may also shift more of the risk of future interconnector development (i.e., risks arising from choices of interconnector capacity, location, and country of connection) away from developers and onto consumers. The assumption that project developers would be able to respond to P2P interconnector needs identified by NGENO also centralises the responsibility for ensuring that identified projects are commercially viable. This raises a potential need for further amendments to the C&F regime design to reflect the associated risk/reward profile.

Relative to the existing regime, proposed changes could lead to:

- a dampening of incentives for developer led interconnector development;
- a narrower pool of potential developers;

³ See [here](#)

⁴ See [here](#)

⁵ See Working Paper 4 of Ofgem's IPR: [here](#)

⁶ I.e., with no 'multi-purpose' attributes

⁷ A P2P interconnector may be anticipatory in the sense that it is built in the anticipation of expected future use of the interconnector's capacity, e.g., linked to future investment in renewable generation between neighbouring electricity systems. However, it is not anticipatory in the same sense as an MPI which may be dependent on the direct investment decisions of other related projects that decide whether or not to utilise the interconnector asset once built.

- less innovation in the design and delivery of new P2P interconnection (e.g., through discouraging alternative project design and financing structures); and
- more expensive interconnection with less risk allocated to remaining investors.

Governance structures and timing

The existing industry governance structure also introduces additional challenges regarding such a role. The NGESO currently has regulatory incentives which are focussed on operation of the system at lowest cost. These incentives would understandably drive NGESO's analysis of the impacts of future interconnection, in particular by placing significant weighting on costs and benefits that it best understands and that it is incentivised to control. This leads to a risk that NGESO could over-weight system operability and network costs relative to other important societal benefits that interconnectors can deliver.

Ofgem and BEIS have recently consulted on major governance changes, proposing a fully independent future system operator (FSO). While this may mitigate some of the risks identified, under either of the proposed models, an FSO would continue to have reputational or commercial incentives which would drive the organisation's priorities.

The extent of governance and structural change required for introduction of the FSO should not be underestimated. Waiting for the development of the FSO to finalise the design of the next C&F window risks delaying and deterring interconnector investment, whilst the thorny details of the new structure are implemented.

Under the OTNR, Ofgem and BEIS's proposals for enhanced coordination within the 'early opportunities' phase are on an 'opt-in' basis stretching out to 2030. In this area of policy, Ofgem and BEIS recognise the disruption that would be caused to near-term project delivery by introducing mandatory coordination requirements without a transitional phase.

For the reasons set out in this note, we would caution against re-centralisation of the regime for P2P interconnection in general. However, if it is determined that an FSO with appropriate governance structures should play a significant role in coordination of interconnection, a similar transition to any new arrangements should be applied to avoid disrupting the existing interconnector pipeline.

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