ANDRIS PIEBALGS
MEMBER OF THE EUROPEAN COMMISSION

PUBLIC VERSION

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Brussels, 18 X 2007
CAB D(2007)/1258

Subject: Exemption decision on the BritNed interconnector

Dear Sir,

I am writing with reference to the decision adopted by Ofgem granting exemption from certain parts of the Electricity Directive 2003/54 and Electricity Regulation 1228/03 for the BritNed interconnector project notified as received by the Commission on 18 July 2007.

The Commission has now completed its analysis of the decision and supporting material. The conclusion of this analysis is that the Commission requests the modification of the exemption decision. The details are set out in the Annex to this letter.

Yours sincerely,

For the Commission,

Andris Piebalgs

Annex

OFGEM
Sir John Mogg
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ANDRIS PIEBALGS
MEMBER OF THE EUROPEAN COMMISSION

OPENBARE VERSIE

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Brussels, 18 X 2007
CAB D(2007)/1258

Betreft: Ontheffingsbesluit inzake de BritNed-interconnector

Geachte heer Frequin,

Ik schrijf u in verband met het besluit van het Ministerie van Economische Zaken tot ontheffing van het BritNed-interconnectorproject van bepaalde onderdelen van de Elektriciteitsrichtlijn (Richtlijn 2003/54/EG) en de Elektriciteitsverordening (Verordening (EG) nr. 1228/2003), waarvan de Commissie op 18 juli 2007 in kennis is gesteld.

De Commissie is thans klaar met de analyse van het besluit en de aanvullende gegevens. De conclusie van deze analyse is dat de Commissie om wijziging verzoekt van het ontheffingsbesluit. Nadere details vindt u in de bijlage bij deze brief.

Hoogachtend,

Voor de Commissie,

Andris Piebalgs

Bijlage

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ANNEX

Procedural

1. The Dutch Minister of Economic Affairs and the British Energy Regulatory Authority (Ofgem) (hereinafter: "national regulators") notified (registered on 18 July) the decisions to exempt the BritNed project from third party access requirements for a review by the Commission. The decisions grant, under the procedure set out in Article 7 of Regulation (EC) 1228/2003, an exemption for a period of 25 years for the full capacity of the BritNed cable. The two national regulators have coordinated their exemption decisions. Nevertheless, the Dutch decision is not entirely the same as the British decision, since it imposes a few conditions which take into account the specific Dutch situation.

2. The Commission asked additional questions to the two national regulators on 7 September 2007. The responses were dated 28 September 2007 and are taken into account in our analysis.

Description of the project

3. There is currently no interconnection between the Dutch and the British electricity markets. There is only a gas interconnector, the Balgzand-Bacton-Line ("BBL") that is designed to flow gas from the Netherlands to the UK which was exempted from regulated third party access in 2005.

4. BritNed Development Ltd (hereinafter: "BritNed") plans to construct and operate a DC electricity interconnector between Great Britain and the Netherlands. BritNed has legal personality under British law and is a 50/50 joint venture of National Grid International Ltd. and Nlink International B.V.

5. National Grid International Ltd. is 100% owned by National Grid plc. which also owns National Grid Electricity Transmission plc., the operator of the British transmission network. Nlink International B.V. is 100% owned by Tennet Holding B.V., owner of Tennet TSO B.V. the latter being the operator of the Dutch transmission network. None of the two transmission system operators (hereinafter: "TSOs") has an interest in supply activities. Tennet also owns 75% of APX, the spot market exchange active in the Netherlands and the UK.

6. The purpose of the BritNed Project is to construct a submarine direct current interconnector with a capacity of 1000 MW, with the possibility for peak capacity of 1320 MW and it is planned to be operational by 2010.

7. The capacity of the cable will be marketed through implicit and explicit auctions on the basis of capacity contracts of different durations. The maximum duration of the capacity contracts is one year. Implicit auctions means that electricity price and capacity price are auctioned together by using bids in power exchanges at each end of the cable. This ensures optimal use of the cable.

8. The investment costs of the project are estimated at EUR […] million[1] and the operation expenditure about EUR […] million/year. BritNed assumes an annual revenue of EUR […] million/year. A study made on income volatility indicated the lowest value of EUR […] million/year and the highest value of EUR […] million/year. With the discount rate of […]% used by BritNed the project has a payback period of […] years. Notably, BritNed has communicated to the Commission that the rate of return which they would internally require for projects with the highest degree of risk is […]%.

9. Although BritNed plans to grant third party access to its cable, it has requested an exemption from regulated third party access (rTPA) since according to the information provided by BritNed,

"it solely wants to ensure the risk/reward balance remains aligned over the duration of the exemption. Investors in BritNed need the assurance that they will not face the downside risks to project returns but will also benefit fully from the potential upside. According to BritNed, if the interconnectior is subject to Article 6(6) of Regulation 1228/2003 and the corresponding UK and Dutch law there would be a danger that, if the interconnector is commercially successful, the returns to investors would be capped, if not entirely removed. However, if it is unsuccessful there is no mechanism for compensating investors. Moreover, according to BritNed, the licensing framework arising from the application of British law prevents BritNed's costs from being socialised, yet can give rise to the regulator being able to demand that the interconnector operator effect capacity expansions at its direction. The authorities may therefore step in if the profits are higher than expected but they are unlikely to step in if the losses are higher than expected. This creates a risk asymmetry which reduces expected returns to below the level that would be acceptable to the investors".

Assessment of the exemption criteria of Article 7(1)

10. The BritNed project was not operational at the date the Regulation entered into force and it is therefore to be considered as a new infrastructure within the meaning of Article 7 of Regulation 1228/2003.

11. In relation to the specific criteria set out in the Regulation Article 7(1) a-f, the Commission has made the following considerations.

a) The investment must enhance competition in electricity supply

– The project will enhance competition by establishing the first interconnection between the British and the Dutch electricity market. The Dutch market is coupled to the French and Belgian market through implicit auctioning of spot cross-border capacity. Implicit auction of BritNed capacity will expand the market coupling in the Northwest European market. Currently, countries in the region also work together to set up market coupling between the Netherlands and Norway on one hand and Germany and Denmark and France on the other hand.

[1] […] indicates confidential information which has been deleted for publication.

– An exemption of BritNed from rTPA does not affect this development as the entire capacity will be available through auctions with maximum contract duration of one year. This is in principle the same as capacity allocation mechanisms on regulated interconnectors at the Dutch-Belgian and Dutch-German borders.

– BritNed has a relatively small capacity compared particularly to the British market, but it will contribute to the convergence of marginal electricity prices, increase liquidity and lead to less volatile and lower average prices. Moreover, BritNed is likely to lower market concentration in both markets as it increases the possibility of British companies to supply the Dutch market and of Dutch companies to supply to the British market.

– Finally, nor the owner of the BritNed interconnector (BritNed Development Ltd) nor its parent companies, National Grid International Ltd. and Nlink International B.V. have interests in supply activities.

b) *the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted*

Since BritNed has no supply interests (nor its parent companies), its revenues are determined by sales of interconnector capacity. Since no capacity is sold under long-term contracts, financial risks of the investment relate predominantly to differences in electricity prices between the UK and the Netherlands. As the risk analysis that is part of the exemption request shows, it is difficult to predict the difference in the electricity prices between the UK and the Netherlands. It is therefore equally difficult to assess the BritNed's future revenues.

The experience from the France – UK electricity interconnector and from other interconnectors shows that the revenue may indeed vary considerably from year to year. For most of the years the income is expected to be rather stable. There is however no equal distribution of instances of high and low revenue. Higher revenues can be very high if special market conditions prevail even during a rather short period of time, for example due to extreme weather conditions affecting only one end of the interconnector. This means that the interconnector investment could amortise very quickly if these instances occur relatively frequently. This has not been taken into account in the calculations which assume that the expected value of income is normally distributed.

c) *The interconnector must be owned by a natural or legal person which is separate, at least in terms of its legal form, from the system operators in whose systems that infrastructure will be built.*

The BritNed cable will be owned by BritNed Development Ltd. BritNed Development Ltd which has legal personality under British law and is a 50/50 joint venture of National Grid International Ltd. and Nlink International B.V. It is therefore legally separate from respectively National Grid Electricity Transmission plc. and Tennet TSO B.V., which are the operators of the transmission networks in Great Britain and the Netherlands. Therefore, criteria c) is met.

d) *Charges are levied on the users of that interconnector.*

The auction price is the charge levied on users. BritNed has the possibility to impose a minimum price.

e) *Since the partial market opening no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the interconnection.*

No part of the capital costs invested has been recovered, since this is a new project.

f) *The exemption is not to the detriment of competition or the effective functioning of the internal electricity market, or the efficient functioning of the regulated system to which the infrastructure is linked.*

The national regulators have taken adequate measures to prevent risks of gaming on the balancing market and to prevent that the UK or Dutch TSO have to pay for bankruptcy or financial problems of BritNed.

In its motivation of the exemption decision, the national regulators have also pointed out that an essential reason for granting the exemption is the fact that under UK law interconnectors cannot be part of the regulated asset base. The Commission considers that this argument does not constitute a valid reason to grant an exemption.[2]

In addition, based on the information provided by the national regulators it cannot be excluded that the project promoters have chosen to construct an interconnector with a sub-optimal capacity compared to what is economically viable and desirable from the point of view of market integration. From a principal viewpoint, the project promoters have an inherent incentive to construct an interconnector with sub-optimal capacity. This strategy allows them to maximise profits by keeping capacity scarce and auction revenues high.

This incentive imposes a duty on the national regulators to verify in detail whether the capacity chosen by BritNed avoids such a monopolistic behaviour and is the most desirable from the point of view of market integration and consumer benefit. ILEX Energy Consulting carried out an analysis on behalf of BritNed examining different interconnector sizes. The consultant assessed the business plan for different capacity sizes of 700, 1000 and 1320 MW while BritNed has decided to build an interconnector of 1000 MW with a peak capacity of 1320 MW for short periods. However, the consultant maintains that, on a net revenue basis, increasing the interconnector capacity to 1320 MW raises the

[2] Following the adoption of the decision by the Commission on 18 October 2007, Ofgem made the following comment which, at the request of Ofgem, is presented here. This comment reflects exclusivley Ofgem's point of view: *'We do not consider that the Commission’s interpretation of our argument is correct here. As part of the information provided to the Commission in support of our decision to grant an exemption, we noted that a holder of a transmission licence may not also hold an interconnector licence. This was presented in support of criteria (c) and (d) in order to demonstrate that adequate ring-fencing was in place between the network operator and BritNed. This issue was not included as part of the justification for our decision to grant an exemption to BritNed in relation to criteria (f).'*

annual average revenues and only at sizes above 1320 MW the annual revenues start to fall. It should therefore have been assessed whether a capacity size of more than 1000 MW with an additional peak capacity would not constitute the optimal capacity.

Therefore the Commission is not convinced that the proposed size of the interconnection cable is the optimal balance between rewarding to BritNed for undertaking the investment and the benefit for consumers on both sides. The exemption decisions of the national regulators do not carry out a sufficiently detailed assessment of the capacity.

The Commission accepts that under the assumptions made in the exemption request an exemption duration of 25 years is in principle justified to amortise the investment. However, it considers that these assumptions display such a high degree of uncertainty that it cannot be excluded that the economics of the project turn out to be profoundly different, in particular in view of the inherent incentive of the project promoters to build a suboptimal interconnector capacity, possibly leading to higher than expected profits. It therefore appears necessary to build in an additional regulatory safeguard at a point in time when the costs of building and operating the interconnector and the benefits of selling the capacity are much better known. Moreover, this point in time should be early enough to remedy a possible capacity inadequacy. On the basis of these considerations, 10 years after start of operations appear the appropriate point in time to reassess the project.

Conclusions

12. The Commission considers for the above mentioned reasons that the decisions to exempt the BritNed project from regulated third party access should be subject to a review ten years after start of operations. This is without prejudice to any rights of review which the national regulators may have on the basis of national legislation.

13. The national regulators are therefore requested to amend their exemption decision to include the following condition:

(a) BritNed has to present to the national regulators within ten years after start of operations (as defined in the exemption decisions) a report that contains all the details necessary to scrutinise the total costs and revenues of the project and the rate of return on the investment with 2007 as the base year allowing for comparison with the data provided for the exemption request.

(b) If, calculated on the basis of the first 10 years, the estimated internal rate of return for the entire project is more than one percentage point above the internal rate of return estimated when filing the exemption request, BritNed shall have two options:

(i) It shall either increase the interconnector capacity to such an extent that the initially estimated rate of return is met. The additional capacity would not automatically be covered by the scope of the present exemption. ; or,

(ii) Alternatively, BritNed shall accept that the profits (discounted to 2007 figures) exceeding the initially estimated rate of return by more than one percentage point are capped and used, at equal parts, to finance the regulated asset base in the UK and in the Netherlands.

14. Therefore by virtue of the third subparagraph of Article 7 of Regulation (EC) No 1228/2003 the Commission hereby requests the national regulators to amend their exemption decisions accordingly within four weeks upon receipt of the present letter and to inform the Commission of this action.