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Sent by email to: cap.floor@ofgem.gov.uk

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Dear Nick,

SSE response to the further consultation on the cap rate for the cap and floor regime for Window 3 electricity interconnectors

The letter is submitted on behalf of SSE Group[1] and is in response to Ofgem's consultation proposing to adjust certain financial parameters within the cap and floor regime for Window 3 electricity interconnectors.[2]

Interconnectors can play a role in supporting the transition to net zero if managed appropriately

We believe interconnectors can play a role in supporting the transition to net zero, meeting the government's legally binding target by 2050 and generally supporting our security of supply. However, we recognise that the role of interconnectors within the energy system, including their contribution to transmission network constraints, will need to be appropriately managed and considered in wider energy policy development to ensure they remain in consumers' best interests.

The success of the interconnector cap and floor regime to date is built upon its stability

A stable cap and floor regime, that has struck a balance between commercial incentives and appropriate risk mitigation for developers, has enabled considerable investment in interconnectors to date and should continue to help reach the Government's ambition of 18GW of connected interconnectors by 2030. This cap and floor regime has supported the deployment of four operational interconnectors to date, plus there are an additional two interconnectors in construction phase and another two interconnectors in development with cap and floor regime agreed in principle.

As an energy infrastructure developer, we therefore have concerns about the negative impacts that the consultation's proposals will have on investment and achieving the government's stated ambitions for interconnectors. In a global race for investment, with supply chains overheating, equity returns should not be dropping.

A piecemeal and late review of the window 3 cap and floor could undermine investment in interconnectors and wider energy infrastructure

While we acknowledge the need to develop and adapt the interconnector cap and floor regime over time (for example, we recognise the need to review the beta value that was set in 2014), it is fundamentally

[1] SSE plc is a UK-listed, FTSE-100 company and provider of low-carbon energy infrastructure. Our purpose is to provide energy needed today while building a better world of energy for tomorrow. Headquartered in Perth, SSE has operations and investments across the UK and Ireland, primarily as a developer, operator and owner of energy assets and businesses, with a strategic focus on regulated electricity networks and renewable energy.
[2] Further consultation on the cap rate for the cap and floor regime for Window 3 electricity interconnectors | Ofgem

flawed to adjust specific parameters within the cap and floor in isolation without reviewing the cost of equity and cost of debt more broadly. Ofgem's Interconnector Policy Review[3] reviewed the broader interconnector cap and floor regime a few years ago, in contrast this consultation just considers a few parameters without considering the fuller impact on cost of equity. We consider that any reviews of the cap and floor regime, or any regulatory financial model, need to be done 'in the round' and consider all parameters together. In the absence of a more robust review, and where there is still considerable uncertainty around different parameters, we believe the interconnector cap and floor regime should stay as is given the need for the regime to stay competitive internationally, attracting investment necessary to enable new electricity infrastructure projects.

We question the appropriateness of changes to the interconnector window 3 cap and floor regime so late in the window 3 project assessment process. This is contrary to precedent in previous windows where the regime information was available earlier and enabled investors to make an informed decision about the attractiveness of the regime earlier in project development cycles. The lack of certainty of the parameters for this and future cap and floor windows further undermines investor confidence.

The proposals also set a worrying precedent for other parts of energy sector, most notably long duration electricity storage (LDES) as the success of the existing interconnector cap and floor regime has been a key driver behind the moves to implement a similar regime to enable investment in LDES technologies. Any implications of the change in the interconnector methodology for the proposed LDES cap and floor regime could deter investment in new technologies.

Specific comments on Ofgem's consultation

Within Ofgem's consultation, we consider there is too much reliance on National Grid Group as a comparator to calculate the equity beta in the interconnector cap and floor regime. The consultation overstates the significance of National Grid Ventures, and its interconnector interests, within National Grid Group. National Grid Group is predominantly a fully regulated network company and, therefore, should not be used, or at least not over-relied on as a comparator.

We also believe the reference to, and reliance on, the RIIO-2 financial settlement is outdated given that Ofgem is in the process of developing the financial framework for RIIO-3,[4] including up to date information for common parameters such as the Total Market Returns (TMR). Where possible, Ofgem should seek to be consistent in its thinking. We recognise, however, that specific differences in the approach are warranted given that the cap and floor and RIIO regimes are distinct regulatory frameworks. For example, the beta estimates and the configuration of the interconnector cap and floor has been undertaken utilising a different approach to RIIO with, for example, the inclusion of generators within the comparator beta group.

While we note the references to the RIIO-2 price control in the current consultation on the cap rate for interconnectors, we acknowledge that Ofgem has not previously drawn any conclusions from the interconnector cap and floor regime when setting the network price controls, such as RIIO-2, and it has not been referenced in the RIIO-3 process to date. It is important to continue to recognise that the cap and floor framework and the RIIO price control framework are distinct processes with specific considerations required to be accounted for in each case. We have therefore not commented specifically on the CAPM and Cost of Capital methodology for the interconnector cap and floor with reference to the

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[3] Interconnector Policy Review - Decision | Ofgem
[4] For example, the RIIO-3 Sector Specific Methodology Decision published on 18 July 2024; RIIO-3 Sector Specific Methodology Decision for the Gas Distribution, Gas Transmission and Electricity Transmission Sectors | Ofgem

financial framework for RIIO-3, as our comments on the RIIO-3 CAPM and Cost of Capital methodology will be separately provided by SSEN Transmission and SSEN Distribution as part of RIIO-3 development.

Ultimately, Ofgem’s current proposals risk undermining investor confidence in interconnector projects and wider infrastructure projects - such changes could hold back the achievement of interconnector ambitions and net zero targets. We do not think now is the time to be interfering with something that is working well and enabling increased investment in energy infrastructure. Now should be the time when efforts to build energy infrastructure accelerates to help us meet net zero goals.

Our response to individual questions posed in the consultation are included within the appendix. We have also included related comments on some other parameters of the interconnector cap and floor that Ofgem did not ask questions regarding.

We are happy to discuss our response further with you or provide any additional information that is required. Our response is not confidential.

Yours sincerely,

Graeme Barton
Regulation Manager

Appendix: Detailed response to Ofgem's further consultation on the cap rate for the cap and floor regime for Window 3 electricity interconnectors

Responses to Ofgem's consultation questions

1. **Do you agree with our methodology for calculating equity beta for Window 3 interconnectors? If not, could you please explain why, provide evidence for your reasons and suggest alternatives? AND**
2. **Do you agree with the comparators we are proposing to use to calculate the beta parameter? If not, could you please explain why, provide evidence for your reasons and suggest alternative methods?**

We understand Ofgem's general methodology for calculating the equity beta is based on the UKRN guidance, which seeks to provide more consistency in the regulated financial framework for various regulated sectors.

Although we recognise the cap and floor equity beta should no longer just be based on one comparator (Drax), we believe that National Grid plc should not be used, or at least not given an equal weight, as a comparator. Ofgem states in the consultation that it seeks to use "listed comparators in the electricity sector which are capital intensive and which either (i) include significant levels of demand risk, or (ii) have existing interconnector businesses with risk profiles similar to the Ofgem cap and floor". However, we do not believe that National Grid plc has significant levels of demand risk and significant exposure to interconnector cap and floor regime as National Grid plc is predominantly a fully regulated network company.

Although National Grid Ventures (NGV) has six operational interconnectors, we consider that NGV is not of significance in the context of the overall National Grid plc which is dominated by fully regulated transmission and distribution networks. Ofgem states that NGV made up 11% of its underlying profit and 19% of its statutory operating profit in 2022/23; however, based on the information in the more recent (2023/24) annual report, NGV's significance had further fallen - NGV was 10% of National Grid plc's underlying profit and 12% of its statutory profit.[5] Additionally, the annual report indicates that around 1.6% of National Grid Group's planned capital investment between 2024/25 and 2028/29 will be via NGV, which indicates that the significance of NGV within the wider National Grid Group will decrease on a forward looking basis.[6] Therefore, we believe National Grid plc should not be used as a comparator, or alternatively should be given a lower weighting when compared to other stocks such as Drax, SSE and RWE, which are more exposed to significant levels of demand risk.

Additionally, we believe the reference to, and reliance on, the RIIO-2 networks price control in this consultation is outdated. The RIIO-2 Final Determination was published in December 2020 and the price control then started in April 2021. Indeed, the RIIO-3 development process is now well underway and the RIIO-3 Sector Specific Methodology Decision was published on 18 July and would be a more appropriate reference. Where possible, Ofgem should seek to be consistent in terms of its latest thinking.

While we note the references to the RIIO-2 price control in the current consultation on the cap rate for interconnectors, we acknowledge that Ofgem has not previously drawn any conclusions from the interconnector cap and floor regime when setting the network price controls, such as RIIO-2, and it has

[5] National Grid plc Annual Report and Accounts 2023/24; page 3; https://www.nationalgrid.com/document/152071/download
[6] National Grid plc Annual Report and Accounts 2023/23; page 21; https://www.nationalgrid.com/document/152071/download

not been referenced in the RIIO-3 process to date. It is important to continue to recognise that the cap and floor framework and the RIIO price control framework are two distinct processes with specific considerations required to be accounted for in each case.

Ultimately, as explained in our earlier overarching comments, we do not think the equity beta should be reduced in the interconnector cap and floor regime. Such proposals will have a negative impact on investment and achievement of government interconnector ambitions. In a global race for investment, with supply chains overheating, equity returns should not be dropping.

3. Do you agree with the proposed approach for determining the Total Market Return parameter? If not, could you explain why, provide evidence for your reasons and suggest alternative methods?

We disagree with the approach used by Ofgem to determine the Total Market Return parameter. As per our response to question 1, references to, and reliance on, RIIO-2 is now outdated.

Other comments on parameters of the interconnector cap and floor not covered by questions

On the risk-free rate (RfR)

The current Ofgem proposals for indexation of the RfR and the determination of Equity Risk Premium (ERP) produce a counterintuitive result of declining returns when the risk-free rate rises. The macroeconomic landscape has shifted significantly since the risk-free rate was set for windows 1 and 2. Increases in RfR negatively impact the cap rate when beta values are greater than 1 (as is the case for interconnectors) ultimately undermining the investment case in interconnectors. The CAPM theory suggests the ERP should be constant, however, that in practise historic ERP does vary through the business cycle (CEPA 2013)[7] but there is evidence (CEPA 2018)[8] for it not being fully correlated with RfR as is currently assumed. This calls into question the proposed use of indexation for the RfR and the methodology for calculation of the ERP.

Investment capital is mobile and can go to preferable international markets where the equity risk premia are more stable above prevailing interest rates. Where there is uncertainty on the methodology applied such as the impact on ERP of indexation of the RfR, we believe the interconnector cap and floor regime needs to stay as is.

On assumed leverage percentages

As the assumed notional gearing in the RIIO-3 (60%) is higher than in interconnector cap and floor (50%), which impacts the cost of equity, we consider that the level of assumed leverage for interconnectors should be given further consideration.

[7] Financeability Study on the Development of a Regulatory Regime for Interconnector Investment Based on a Cap and Floor Approach, CEPA, 20 February 2013 (ofgem.gov.uk) p50
[8] Review of Cost of Capital Ranges for Ofgem's RIIO-2 for Onshore Networks, CEPA, February 2018 (ofgem.gov.uk) p59