

19 August 2024

Ofgem
10 South Colonnade, Canary Wharf
London E14 4PU

By email: cap.floor@ofgem.gov.uk

Response to Ofgem's Consultation on the cap rate for the cap and floor regime for Window 3 electricity interconnectors

Dear Sir/Madam

MaresConnect Limited (**MCL**) welcomes the opportunity to respond to Ofgem's Consultation on the cap rate for the cap and floor regime for Window 3 electricity interconnectors (the **Consultation**), published on 12 July 2024.

MCL is the developer of the 750MW MaresConnect Interconnector project between GB and Ireland (**MaresConnect**), which has applied for initial project assessment in Ofgem's third cap and floor window (**W3**). MaresConnect is a point-to-point interconnector between Bodelwyddan in Wales and North Dublin in Ireland. Further information on MaresConnect can be found at: www.maresconnect.ie.

We welcome the opportunity to provide feedback on the methodology and parameters proposed for calculating the financial aspects of Window 3 interconnectors under the cap and floor regime. We have several concerns and suggestions regarding the equity beta, comparators used, and the Total Market Return (TMR) parameter which we have set out in this consultation response.

We have also reiterated an extract from our response to Ofgem's September 2023 consultation on changes to financial parameters of the cap and floor regime for window 3 electricity interconnectors, given its relevance to the current consultation.

Our comments reflect the perspective of a developer of a privately funded interconnector.

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1. Do you agree with our methodology for calculating equity beta for Window 3 interconnectors?

We do not fully agree with the proposed methodology for calculating the equity beta for Window 3 interconnectors. The current methodology does not adequately account for the unique operational and financial risks faced by offshore interconnectors, which are significantly different from those of onshore transmission assets.

Higher Operational Risks

- Offshore interconnectors face significant challenges in maintenance and repair due to harsh marine conditions, which lead to higher operational costs and increased risk of prolonged outages¹.
- Environmental exposure, such as saltwater corrosion and strong currents, accelerates wear and tear, necessitating more frequent and costly maintenance interventions.
- Advanced HVDC technology used in offshore interconnectors, while efficient, is complex and can be prone to technical failures, impacting reliability and financial stability.

Jurisdictional and Compliance Risks:

- Offshore interconnectors operate across multiple jurisdictions, each with distinct regulatory and compliance requirements, adding layers of complexity and cost.
- Navigating different regulatory frameworks and adapting to changes requires significant resources, increasing operational risks and financial burdens.

Market Risks:

- Offshore interconnectors are subject to demand variability and market price fluctuations in multiple countries, leading to revenue instability and challenges in operational planning.
- Capacity constraints during peak times or unexpected surges in demand can strain the interconnector, potentially leading to service interruptions and financial losses.

¹ [Understanding the risks for subsea interconnector projects | Marsh](#)

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Financing Risks:

- Interconnectors require an adequate level of potential returns to attract investment from capital markets. Using equity betas from industries with lower risk profiles to construct a capped rate of return may result in insufficient returns to attract investment.

2. Do you agree with the comparators we are proposing to use to calculate the beta parameter?

Lack of Pure Play Comparables:

- There are no pure play quoted comparables for offshore interconnectors, making it difficult to derive an accurate beta from existing listed companies. The unique risk profile of offshore interconnectors is significantly higher than that of onshore transmission assets or diversified utility companies.
- The inclusion of comparators with greater exposure to lower risk onshore grid transmission assets risks understating the equity beta. This is shown by the average notional equity beta increasing from the proposed 1.07 to 1.23 when excluding National Grid and Iberdrola².

Single Asset Companies:

- Many interconnectors are held by single asset companies rather than large, regulated entities like National Grid, RTE, and TenneT. Single asset companies face higher concentration risk, as they cannot diversify risk across multiple assets, justifying a higher equity beta to reflect the additional financial risk.

Comparators for Beta Calculation:

- The proposed comparators for calculating the beta parameter do not fully capture the unique risks associated with offshore interconnectors. Including a broader range of companies with significant offshore operations and exposure to marine environments is necessary.

² Appendix 1, Table 1

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Need for Specialized Comparators:

- Comparators should include companies involved in offshore wind energy projects and subsea cable installations, which face similar operational challenges.
- While not directly comparable, major oil and gas companies operating offshore, especially those engaged in deep-water drilling, should be considered. These companies share operational and environmental risks, as well as exposure to commodity price fluctuations, similar to the market and operational risks faced by offshore interconnectors.
- As an example, when including the notional equity betas of BP PLC (BP.L), Shell PLC (SHEL.L) and Total SE (TTE.L), are noticeably higher than Ofgem's average at 1.54, 1.86 and 1.58 respectively³.

3. Do you agree with the proposed approach for determining the Total Market Return parameter?

Total Market Return (TMR) Parameter:

- The proposed approach for determining the TMR parameter does not sufficiently account for the higher risk environment that offshore interconnectors operate in compared to traditional onshore assets.

Higher Risk Environment:

- Offshore interconnectors face greater operational and environmental risks, which should be reflected in a higher TMR to ensure adequate investor compensation.
- The unique challenges and costs associated with maintaining and operating in marine environments necessitate a higher return to attract and retain investment.

³ Appendix 1, Table 1

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Historical Market Conditions:

- The proposed TMR methodology appears to be based on historical data that may not adequately capture the current and future risk landscape for offshore interconnectors.
- A forward-looking approach that considers recent market developments and the evolving risk environment is necessary for an accurate TMR assessment.

Debt Beta:

- The inclusion of a debt beta of 0.075 in the methodology requires careful consideration. While this aligns with wider regulatory practices, it impacts the calculation of the asset beta, which in turn affects the equity beta. Given the high operational and financial risks associated with offshore interconnectors, a higher debt beta could lead to an underestimation of the equity beta, potentially resulting in lower returns that do not adequately compensate investors.
- Ofgem's Cap & Floor regulation provides a guaranteed floor return for interconnectors, a feature that is notably distinct from other regulatory assets. This guaranteed floor acts as a form of credit support, effectively reducing the risk to debt holders to a level comparable to sovereign debt. Given this robust underpinning, the debt supported by the floor level is substantially insulated from the risks typically associated with corporate debt. Consequently, the correlation to broader corporate debt markets diminishes, making a strong case for setting the debt beta at zero.

Previous response to September 2023 Ofgem Consultation

(Question 4.) Do you agree with the issues raised and the proposed changes to the cost of equity? If not, could you please explain why and provide evidence for your reasons as well as provide alternatives?

Ofgem's proposal appears to be rooted in the desire to streamline its calculations across regulated assets, rather than adhere to sound corporate finance principles.

We are not supportive of the proposed change to align with the RIIO -2 price controls. RIIO-2 focuses on the regulation of a portfolio of mature, onshore

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assets located in the United Kingdom, held by a few large well-capitalised organisations. Interconnectors operate in an environment with significantly different risk characteristics.

- A large proportion of an interconnector's asset base is located offshore in a volatile environment. The risk to maintain or repair HVDC cables offshore is not comparable to an overhead transmission line or an onshore gas pipeline.
- Interconnectors operate in two or more jurisdictions where part of the asset may be regulated under a different regulatory model and laws than in GB. The combination of multiple regulatory models, tax rules and local laws increases the overall financial risk to equity providers.
- Most interconnectors are held by single-asset companies and do not benefit from a broad, diverse group of comparable assets. Interconnector owners are unable to diversify away the concentration of risk on a single asset.

We note the references made to CEPA's work in 2018 and 2013. CEPA's own conclusion after extensive review of an interconnector equity beta was framed succinctly "*We are therefore inclined to take the evidence from 2010-14, which Ofgem used to set an equity beta of 1.25 at 50% gearing, as the best available evidence, and do not propose a change to the equity beta parameter.*" We also concur with this view. Before making any changes to the fundamental building blocks of the cap & floor model, it would be helpful for Ofgem to provide new evidence supporting the alignment of interconnectors to RIIO-2 assets and follow a more detailed consultation process.

Suggested Alternatives and Further Work:

To address the concerns set out above, we have the following recommendations for Ofgem:

- Consider using a higher equity beta to reflect the unique risk profile of offshore interconnectors, potentially above the 1.25 used in previous assessments.
- Expand the list of comparators to include companies with extensive offshore operations, such as offshore wind farm operators and companies involved in subsea cable installation and maintenance, as well as major oil and gas companies operating offshore.

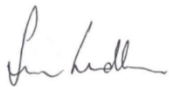
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- Adopt a forward-looking approach for TMR that incorporates recent market data and trends to better reflect the current risk environment.
- Conduct a comprehensive review involving industry stakeholders to gather empirical data on the operational risks and financial challenges faced by offshore interconnectors.

An independent expert review of the proposed beta methodology and TMR should be conducted to ensure they adequately capture the unique risks associated with offshore interconnectors.

We are available to discuss further any of the points made above.

Yours sincerely,



Simon Ludlam

CEO

Mares Connect Limited

E: simon.ludlam@mareconnect.ie

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Appendix 1 – Beta Tables including Oil & Gas Comparators

Table 1: Notional Equity Betas

Component	Ofgem Average	Ofgem Average excl. NG, IBE	BP	Shell	Total SE
Spot raw beta	0.80	0.86	1.47	1.41	1.22
Observed gearing over period	31.18%	25.16%	47.60%	34.04%	35.08%
Unlevered beta	0.55	0.63	0.77	0.93	0.79
Debt beta	0.075	0.075	0	0	0
Asset beta	0.57	0.65	0.77	0.93	0.79
Notional gearing	50.00%	50.00%	50.00%	50.00%	50.00%
Notional equity beta	1.07	1.23	1.54	1.86	1.58

Source: Yahoo Finance, Morningstar UK, SEC 20-F records

BP, Shell and Total SE betas calculated with zero debt beta in line with the Debt Beta section on page 5.