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**Norwegian Ministry of Petroleum and Energy**

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**NorthConnect's consultation response regarding proposal for amendments to the Energy Act****Background**

The NorthConnect project is a joint venture planning to build and operate an HVDC interconnector between Norway and the UK. The company is owned by: Vattenfall (SE), Scottish and Southern Energy (UK), Agder Energi (N), Lyse (N) and E-CO (N). The owners are all reputable energy market players with necessary financial capacity and skills for execution of such large infrastructure projects.

Reference is made to the proposal from the Ministry of Petroleum and Energy (MOPE) dated 18th of September 2012 regarding certain amendments to the Energy Act and the associated public consultation process.

The proposal seeks to clarify the legal framework for licenses for cross border interconnectors, and aims to adjust the current provisions in the Energy Act in order to bring them in conformity to the EEA Agreement. One important backdrop for the proposal is that the European Surveillance Authority (ESA) in a letter of July 1, 2011, requested MOPE to clarify Norway's implementation of directive 2003/54/EF, including the implementation of the provisions on infrastructure licenses. In the above mentioned proposal for amendments to the Energy Act, MOPE proposes that the TSO (Statnett) shall own or have a controlling ownership of all interconnectors out of Norway. If the proposal is adopted, NorthConnect and similar initiatives with the participation of commercial players will effectively be stopped.

MOPE puts forward two main arguments to support the proposal. First, it argues that Statnett is best positioned to view the domestic grid system and interconnectors in context; second, MOPE argues that income from merchant interconnectors would benefit the owners, and not other users of the central grid.

From NorthConnect's viewpoint, neither argument is valid to justify a ban on merchant interconnectors.

Planning of new interconnectors and development of the onshore central grid is thoroughly regulated through the existing license processes, i.e. license to build ("anleggskonsesjon") and license to trade abroad ("konsesjon for utenlandshandel"). NVE and MOPE will have full insight into and control of licenses granted, and – in the event of competing or mutually exclusive interconnector projects – to decide which projects should be granted the necessary licenses. Consequently, MOPE will be in the position to ensure that new interconnectors do indeed satisfy any relevant planning, coordination and socio-economic benefit criteria, independent of ownership.

As for distribution of the economic benefits, the most important issues are that the interconnector is used in compliance with the interconnection regime, and that its capacity is available on a non-discriminatory basis. This is ensured through license conditions, independent of ownership. The profit over time from interconnectors is not likely to produce a super-profit in excess of a fair return on capital, and MOPE has not presented any evidence that this has historically been the case or is likely to be the case in the future. However, profit from existing Statnett owned interconnectors has previously caused a substantial volatility of the central grid tariffs, causing the tariff levels to change dramatically from one year to the next.

MOPE will have several options to ensure that income from a merchant interconnector in excess of a fair return on capital will benefit the central grid and contribute to either investment capacity or reduced tariffs. As merchant interconnectors will be subject to revenue regulation, both revenue caps, capacity payment through residual tariffs and taxation on super profit are available options.

There are several examples of such regulation models. Experience from previous merchant interconnector projects in EU - e.g. the recent Cap and Floor model proposal from Ofgem in UK - shows that new merchant interconnector projects will be subject to revenue and return regulations. Alternatively, tax mechanisms as applied to hydro power plants and petroleum industry can be used in order to capture superprofit from merchant interconnector projects. Consequently, merchant interconnector projects offer the regulators the feature to decide the risk and profit sharing between interconnector owners and consumers.

It is worth noting that also a TSO owned interconnector may *increase* and not decrease the central grid tariff, as there is no guarantee that an interconnector will be profitable over its lifespan. Such volatility introduces additional risk to consumers and to industry. The Norwegian energy-intensive industry represented by the largest player Hydro also supports a supplement to traditional TSO interconnectors: *"Establishment of new interconnectors with related grid reinforcements on land involves a significant financial risk for energy-intensive industries, especially the first 10-15 years if current practices continue. Hydro believes that investments related to such projects must be held outside the central grid accounts, and organized into separate units by either Statnett or other players."* (Hydro's consultation response regarding the Electricity Certificates Act from 1st of March 2011). The ongoing review of the ITC annual cross-border infrastructure compensation sum serves as just one illustration of the high market and regulatory risk associated with interconnector investments.

### **Key issues related to the Ministry's proposal**

The Ministry, as requested by ESA, in the proposal has clarified the relationship between construction licensing under the Energy Act § 3-1 and foreign licensing pursuant to the Energy Act § 4-2, and specified the activities that require a license. NorthConnect supports the clarification of the legal framework for awarding licenses (foreign trade and construction) to cross border interconnectors.

Furthermore, the Ministry's proposal states that license for ownership or operation of cross border Connections will only be granted to the Transmission System Operator (TSO) or to an entity where the TSO has controlling interest. In Norway the TSO is Statnett. In the Ministry's view, this means a continuation of the principle that interconnectors will be owned and operated by the operator of the transmission system in line with the EU's third energy package.

However, ESA's assessment of the Norwegian foreign licensing scheme provides in our view no support to include a restriction on ownership of interconnectors to Statnett-dominated companies in the amendments to the Energy Act. In addition, there is nothing in the third energy package which prevents Norway from certifying more than one TSO.

In the proposal, MOPE's justifications for the proposed rules are i.e., that the amendments will safeguard "general public interests" such as security of supply, the environment and resource management/control over the grid development. In addition, the reason for the limitation on who can obtain a license is based on the presumption that the system operator has the "best ability to view the portfolio of foreign connections in the context of the domestic energy system" (our translation) and has the best position to consider and coordinate the expansion and the maintenance of the domestic grid.

The license regime for a foreign license is a restriction on the free movement of capital, a concept that is enshrined in Article 40 of the EEA Agreement. That said, a restriction can indeed be legal if the restriction pursues a legitimate aim and if the restriction does not go beyond that being necessary (proportional).

The considerations listed by MOPE could indeed be viewed as legitimate grounds per se. However, in our view, the objectives as identified can be met through suitable conditions invoked in the license arrangement which are less infringing than an outright ownership restriction. In accordance with the proposal by MOPE, when an application for a foreign license is evaluated, emphasis must be placed on the project's socioeconomic benefits, relationship to any competing projects and transparent and non-discriminatory considerations in general. The state will in all aspects have the possibility to control the considerations mentioned, such as security of supply and environmental issues.

**All the asserted considerations will therefore be satisfied through the license arrangement which already exists, including the proposed specifications to this arrangement. Thus, the ownership restriction goes beyond what is necessary, and is an illegal restriction under the EEA Agreement.**

### **Lack of impact assessments related to the Ministry's proposal**

NorthConnect would like to emphasize that the Assessment regulation ("Utredningsinstruksen") requires that all proposed amendments shall be subject to an impact assessment before they are sent on public hearing. The impact assessment shall i.e. include an analysis of significant consequences for affected public and private parties. NorthConnect cannot see that the Ministry has conducted any assessment of what the proposed ownership restrictions will imply for security of supply. If the proposed amendments are adopted, the consequence will be that the establishment and building of new interconnectors will be delayed or stopped. Furthermore, NorthConnect fails to see that the consequences for private parties involved in ongoing interconnector projects have been assessed. From NorthConnect's point of view, the Ministry has not complied with the requirements of the Assessment regulation. The potential consequences should be assessed before any ownership restrictions are adopted.

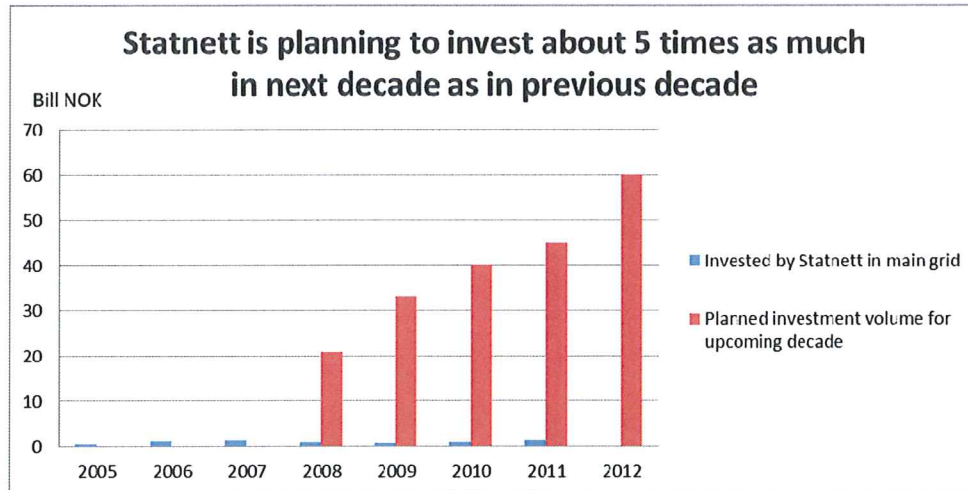
The construction of new interconnectors may be justified on a combination of benefits, especially increased security of supply, market integration and more stable power prices. MOPE has not presented any analysis on either issue in the proposal, and we consider this a non-compliance with the Assessment regulation. In particular, we are concerned that MOPE has not considered the extreme strain on Statnett's capacity to develop new projects over the coming decade.

Statnett faces a dramatic increase in investment over the next 10 years, i.e. about five times the investments in the preceding decade. Statnett plans to invest about 50-70 billion NOK alone. The common green certificate market with Sweden, EU renewable 2020 targets as well as bottlenecks in the domestic grid and security of supply are key drivers for the development of grid and generation.

We should also point out that Statnett in a recent Grid Study has a very conservative view on potential interconnectors (no shutdown of the cables due to operational irregularities).

As we see it, balance between production capacity and demand may develop in such a way that the need for interconnector capacity exceeds Statnett's careful conclusions. Statnett's plan for interconnector capacity in the future is conservative from two perspectives. First, various possible scenarios for market development are poorly analysed and do not include the scale of forced down-regulation of new renewable generation in different scenarios - with the associated economic losses. Furthermore, security of supply has not been considered when the interconnectors are utilized according to market prices at both ends and this is combined with a restriction on the use of interconnectors due to weakened security of supply either in Norway or the connected country. Then it is a possible scenario that several new interconnectors can be connected to the Norwegian Grid, and thus further add to the already strained Statnett investment plan.

This issue should be taken into account in a more comprehensive impact assessment of the proposal.



Consequently, Statnett's project realization capacity is already stretched to its limits with the planned on-shore projects. In addition, lack of engineering and construction capacity in the market will further complicate realization of large infrastructure projects. MOPE should explicitly assess Statnett's capacity to take lead in all interconnector projects, and the risk of major delays or non-realization due to capacity constraints. Major delays in interconnector development and realization may seriously hurt both security of supply, market integration, stable prices and climate targets.

In that context a non-TSO project will be a good supplement to the TSO projects, as it can be regulated adequately through the licensing processes. A non-TSO project will provide the same benefits to society (increased welfare, climate change protection, market integration and security of supply) and will be operated in the same way as TSO interconnectors given adequate regulation.

If implemented the proposal will delay or stop the ongoing NorthConnect project and remove the incentives for future private development of new interconnectors from Norway. The aim of the third electricity directive and the regulation is to increase the number of interconnectors in order to integrate the European energy market – not limit, as the proposal will do by restricting ownership. The NorthConnect project has a significantly lower capex than the North Sea Network project due to significantly shorter cable length. Consequently, the implication of current proposal may be that an interconnector project to UK with low capex and high social welfare may be terminated due to ownership restrictions.

The Ministry's proposal states that the relevant license assessments must be based on objective, transparent and non-discriminating criteria. However, the assessment of the grid connection for an interconnector project is currently carried out solely by the TSO without verification of National Regulatory Authority (NRA). NorthConnect sees a need for a strong and independent NRA in order to secure transparency in the process related to licensing of interconnectors as addressed in EU's third energy package. However, the Ministry's proposal will reduce the scope for the NRA and increase the mandate of MOPE. A weakening of the NRA's role is not considered to be in line with the aim of the third energy package. Some of NorthConnect's owners have experience from a previous interconnector project where the assessment of the grid connection for an interconnector both lacked transparency for the applicant and the NRA as well as verification by the NRA. NorthConnect is therefore of the opinion that MOPE needs to include in the proposed amendment measures to secure transparency in the evaluation of licenses related to foreign trade and construction for interconnectors. The implementation of EU's third energy package in Norway should be addressed as part of the impact assessment before any ownership restrictions are adopted.

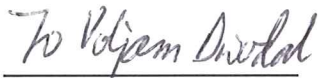
## Conclusions

The implication of the proposed amendments to the Energy Act from the Ministry is in reality an introduction of a state monopoly on interconnectors to Norway. The practical implications of such change in the legislation regarding the future development of interconnector capacity from Norway need to be addressed in an impact assessment related to increased welfare, security of supply,

market integration, stable prices and climate targets. Especially, Statnett's capacity to develop and realize new interconnectors must be assessed.

- The proposed amendments have not been subject to a thorough impact assessment in line with the Assessment regulations (Utrekningsinstruksen). All proposed amendments shall be subject to an impact assessment before they are sent on public hearing. The assessment should give a thorough analysis of significant consequences for affected public and private parties. Such an assessment should be done before the proposed amendments are sent out on a new public hearing.
- In our opinion the ownership limitation in the proposal is not required in order to implement the third energy package. There are no provisions in either the Electricity Directive or in the Cross-border Regulation that state that only entities controlled by system operators or TSOs should be eligible for license for new interconnectors or exemptions under the Cross-border Regulation.
- In addition, the proposed amendments related to ownership are in conflict with Norway's obligations under the EEA agreement. The license regime for a foreign license is a restriction on the free movement of capital as that concept is enshrined in Article 40 of the EEA Agreement. In our opinion, the considerations listed by MOPE can be met with means that are less infringing on the internal market than the proposed ownership restriction – e.g. by invoking suitable conditions in the license regime.
- The aim of the third electricity directive and the regulation is to increase the number of interconnectors in order to integrate the European energy market – not limit, as the proposal will do by restricting ownership. Given the scale of potential implications of the proposal, NorthConnect demands an assessment of the impacts of introducing a monopoly on interconnectors as the proposed amendments to the Energy Act from the Ministry in reality means before the proposal is concluded and submitted for decision.
- If the proposed amendments to the Energy Act are approved and implemented, NorthConnect will bring the case before ESA.

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