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Agency for the Cooperation of Energy Regulators
Mr. Alberto Pototschnig
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1000 Ljubljana

Slovenia

Berlin, 21 February 2018

Dear Mr. Pototschnig,

you are currently consigned to make a decision on the exemption of the AQUIND interconnector project, subject to Art. 17 of Regulation (EC) 714/2009. The regulation requires – inter alia – that "the level of risk to the investment is such that the investment would not take place unless an exemption is granted". This requirement can hardly be substantiated: DC interconnections are today an established technology, technological risks are well-known and many regulated solutions have been realized (e.g. the Kontek interconnector, EstLink II, LitPol, SwePol etc.). In that respect, an exemption does not seem to be adequate under Art. 17.[1]

More than that, from a social welfare perspective, when allowing for an interconnector to be exempted, there is a great chance that a large share of additional rents realized by the interconnector will be pocketed by the operator of the interconnector: This is due to the fact that both countries' power market prices are formed on the basis of national bidding zones and do not take into account detailed information of the transmission system (this also holds when flow-based market coupling is in place). Therefore, a transmission expansion between countries is barely reflected in a change of prices. While there should be real overall increases in welfare due to increased interconnection, the price difference (on which the merchant operator's earnings are based) only decreases to a very minor extent which leads to revenues for the operator that are far higher than could be justified compared to his welfare contribution. This is – to some extent – also reflected in London Economics' study on the ElecLink interconnector where it was found that rents could be supposed to be relatively high.

Therefore, the drawback of merchant interconnectors in zonal markets is not under-investment (as sometimes pointed out in literature), but distributional issues that direct welfare gains towards the merchant operators, while the rest of the society (i.e. consumers and producers) is barely better off than before. We have analyzed this effect in a publication which will soon appear in the journal "Energy Policy".[2] Using a two-level model of interconnector investments in the Baltic Sea Region, we analyze the impact of profit-maximizing merchant transmission investment as compared to welfare-maximizing regulated transmission investment. We obtain stable results indicating that merchant investment may positively contribute to overall welfare, but at the same time, "the merchant takes it all," i.e. in many cases merchant profits are close to the overall efficiency gain. This underlines that distributional aspects, beyond mere welfare arguments, should be taken into account when analyzing the impact of merchant transmission investment.

[1] Commercial risks are not of any matter here: In the regulated case, to which a merchant project needs to be compared to, revenues are virtually risk-free.
[2] Gerbaulet/Weber (2018): When regulators do not agree: Are merchant interconnectors an option? Insights from an analysis of options for network expansion in the Baltic Sea region. Energy Policy, forthcoming.

Interestingly, the effect of the merchant being the sole beneficiary can to some extent mitigated by a profit transfer rule such the one that was imposed in course of the exemption of the ElecLink interconnector. Yet, it is unclear from which level on profits would be transferred to a regulated body. Given the experiences of numerous regulated DC interconnection projects, it seems hard to believe that this -- non-transparent -- approach should be superior to regulated solutions which would also benefit from lower risk premia.

Therefore, in light of the highly problematic “risk argument” and the severe distributional impact which would be to the detriment of the interests of European citizens (including those of the UK), we strongly suggest not to exempt the AQUIND project from regulation but to advise regulators to induce development of such a project under a regulated tariff.

We are available for detailing our arguments to you at your convenience.

Yours faithfully,

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Dr. Alexander Weber　　　　　　　　　　Dr. Clemens Gerbaulet