

Embracing Merchant Transmission Investment

Written by Brian Johnson on 19 October 2018 in Opinion Plus
Opinion Plus

Regulatory policy for efficient electricity markets should establish merchant transmission investments as the 'default' option, argues Professor William W. Hogan.



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Market-based, or merchant, transmission investments are motivated by the potential profits from enabling the transmission of power from lower cost to higher cost locations.

They are economically attractive to investors able to identify and contract in advance with the potential beneficiaries. Alongside regulated public investments, they support the development of electricity transmission infrastructure needed for the integrated Internal Energy Market in Europe.

Regulatory policy for efficient electricity markets should establish merchant transmission investments as the 'default' option, supplemented with regulated investments for cases where market

imperfections impede merchant involvement in investments that are in the public interest.

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Since the 1990s, this merchant model has driven the development of the generation and retail sectors of electricity markets.

The EU policy for cross-border interconnectors, through Article 17(1) of [Regulation 714/2009](#) [7], is inconsistent with market-driven principles, because it assigns regulated interconnectors as the 'default' option. Merchant investments need to be extensively justified to obtain regulatory exemptions.

The case of the proposed Aquind Interconnector between England and France, whose requested exemptions have been [rejected](#) [8] by the Agency for the Cooperation of Energy Regulators (ACER), illustrates the challenges faced by investors in merchant interconnectors. Our view is that ACER's decision is unlikely to be in the interests of European consumers.

Unsupported Counterfactual

ACER finds that the transmission Aquind would provide is socially beneficial, yet rejected Aquind's requested exemptions.

For this decision to be consistent with the regulatory objective of social efficiency, ACER must be implicitly assuming that a regulated interconnector will be developed as an alternative.

However, there are no alternative projects being developed and there is no apparent appetite by national TSOs (or by Aquind) to develop a similar regulated interconnector.

Project Risk Not Reduced by Regulated Alternative

ACER considers that the interconnector cost would be lower if the project were undertaken by a regulated entity because of a reduction in risk.

ACER's conclusion is correct for investor risk, i.e., uncertainty regarding the level of the return on investment, but it fails to separately consider project risk.

Project risk is the uncertainty about likely project costs and future revenues. It is distinct from investor risk, and is not reduced for a regulated investment versus a merchant investment.

Imposing regulation on the interconnector project would simply transfer project risk (of cost overrun

and/or revenue shortfalls) to customers paying tariff rates for electricity; this risk would not disappear.

ACER appears not to consider the project risk it imposes on customers, rather than investors, in advocating a regulated investment as the default.

Regulated Customers Bear both Costs and Benefits

ACER's decision appears to rely on the untested assumption that the project will generate positive net revenue, which in its view should be allocated to consumers rather than an independent developer.

ACER does not consider the downside risk – i.e., the possibility that the interconnector is unprofitable – in which case the shortfall would be recovered from customers under a regulated approach.

ACER's conclusion that regulated links are preferable to ensure the benefits flow to consumers is flawed because it ignores the risk that the benefits are negative.

Prioritizing regulated over merchant investments is only economically justified in instances of identified market failures, which do not appear to exist for the case of Aquind.

Furthermore, in applying existing EU rules, ACER rejected Aquind's requests based on the supposition of an alternative regulated project that does not exist and, by doing so reduces social welfare.

Absent an alternative regulated proposal, as in the AQUIND case, the current rules imply that the merchant exemption should be approved.

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