

To transmission companies,
distribution companies,
generators, suppliers, shippers,
offshore transmission owners,
customer groups and other
interested parties.

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Presumed interest rate for Network Innovation Competition (NIC) Projects

Innovation is a key element of the RIIO (Revenue = Incentives + Innovation + Outputs) price control framework. Developing innovative approaches is essential for network operators to deal with the challenges they face. The NIC funds a small number of flagship innovation projects that will deliver financial, carbon and/or environmental benefits for customers. Funding for the NIC is provided by customers through transmission network use of system charges.

This letter seeks evidence on the level of interest payments licensees receive when they deposit the funding they use to implement NIC projects in a relevant bank account (the Project Bank Account¹).² We³ recently consulted on minor changes to the NIC Governance Document which provides for funding adjustments in respect of the presumed rate of interest receivable on these deposits.⁴ Some respondents noted that we should consider the interest payments licensees receive as part of making the minor amendments to the NIC Governance Document. In our decision relating to changes to the Governance Document⁵ we recognised the concern expressed by stakeholders. However, we noted that any changes to the presumed rate of interest would be a substantive change to the NIC governance arrangements. We said that we would address this issue when we undertake the two-year review of the NIC.

Since we published our decision, one licensee has contacted us expressing its concern in relation to the presumed rate of interest and other licensees echoed this concern in a recent industry meeting. We are minded to amend the Governance Document where robust evidence is provided by respondents to support a change. This letter seeks evidence on the extent to which this is an issue for licensees.

We will consider whether any amendments are needed to provide for a different presumed interest rate for projects which have not yet been awarded funding following our consideration of responses to this consultation.

Presumed interest rate

¹ The term "Project Bank Account" has the meaning given to it in the NIC Governance Document.

² The full NIC funding for a project is deposited into the Project Bank Account in the first full financial year of a project.

³ The terms "we", "us", "our" "the Authority", and "Ofgem" are used interchangeably in this letter. The Authority is the Gas and Electricity Markets Authority. Ofgem is the Office of the Authority.

⁴ <https://www.ofgem.gov.uk/publications-and-updates/proposed-changes-network-innovation-competition-and-network-innovation-allowance-governance-documents>

⁵ <https://www.ofgem.gov.uk/publications-and-updates/decision-proposed-changes-network-innovation-competition-and-network-innovation-allowance-governance-documents>

The relevant parts of the NIC Governance Documents provide the following:

"NIC Funding Request: *The Outstanding Funding Required, including a deduction for the bank account interest that the Network Licensee will earn on the balance of funding over the duration of the Project*²³.

The Network Licensee's Funding Request is automatically calculated within the Full Submission Spreadsheet which Ofgem will provide two months prior to the Full Submission deadline. The bank interest shall be calculated at midyear using the Bank of England base rate plus 1.5 per cent on 30 June of the year in which the Full Submission is made."

The NIC Governance Document therefore expects that bank interest shall be calculated at midyear using the Bank of England base rate plus 1.5 per cent on 30 June of the year in which the Full Submission is made. The Governance Document and the submission spreadsheet provide that payments implied using this presumed interest rate are to be subtracted from the funding request. This is because the presumed interest payments should mitigate the resulting shortfall.

The level of interest the current Governance Document presumes licensees will receive was first used in version three of the Low Carbon Networks (LCN) Fund Governance Document, published in 2010⁶. It has been used in all relevant versions of the LCN Fund Governance Document (this was removed from version seven of the LCN Fund Governance Document as it is no longer needed).

We have consulted on every version of the Governance Document and stakeholders have not raised concerns in relation to the presumed interest rate. However, we recognise the concerns recently raised by licensees in respect to the presumed interest rate.

We would like to know what level of interest rate licensees and other interested parties receive (or provide, in the case of financial institutions) for large deposits. We understand that a number of factors can affect the level of interest payments financial institutions are willing to provide. Most NIC projects will involve multi-million pound deposits, in a number of tranches over the first twelve months of the project, and withdrawals taking place which can be pre-planned and take place over a number of years. We understand that financial institutions are likely to provide higher rates of interest where funding has been deposited for a fixed amount of time.

Question 1: What level of interest would you expect to provide or receive for a large capital deposit made in 2016/17?⁷ Please explain the factors that affect the level of interest provided such as length of deposit and prior knowledge of withdrawals.

Cost to licensees

At least 10% of the funding for LCN Fund and NIC projects must be provided by licensees. The remaining 90% is funded by customers through network charges. As noted above, the interest that would be received, calculated using an presumed rate of interest, is subtracted from the funding request. A shortfall in the funds received because of a higher rate of presumed interest can mean that licensees need to provide additional funds not anticipated in the governance arrangements.

To establish the extent to which licensees may be exposed to these potential additional costs we are seeking the views of interested parties on this issue.

⁶ <https://www.ofgem.gov.uk/publications-and-updates/low-carbon-networks-fund-governance-document-v.3>

⁷ 2016/17 is the financial year during which funds for successful projects from this year's competition will be deposited in project bank accounts.

Question 2: What level of interest payments have licensees received in the bank accounts they have used for their project bank accounts and how were shortfalls in payments, if any, resulting from calculations using the presumed interest rate addressed by licensees that have begun LCN Fund or NIC projects? Please provide evidence.

Next steps

We welcome responses to the issues we have raised in this letter by **16 May 2015**. Responses should be sent, preferably by email, to networks.innovation@ofgem.gov.uk or in writing to:

Neil Copeland
Ofgem - Glasgow
107 West Regent Street,
3rd Floor,
Cornerstone,
Glasgow
G2 2BA

Unless marked confidential, all responses will be published by placing them on our website. We intend to publish a decision affecting this year's competitions before we circulate the submission materials, which we will issue no later than the end of May 2015.

We will consider whether any amendments are needed to the NIC Governance Document to provide for a different interest rate following our consideration of responses to this consultation.

We will consider any enduring changes that may be required to the NIC Governance Documents as part of the two-year review. We plan to undertake this review over the summer and autumn of this year so that any changes can be made to the Governance Documents in time for the 2016 competitions.

Should you wish to discuss the issues raised in this document, please contact Neil Copeland at neil.copeland@ofgem.gov.uk or on 020 7901 7193.

Yours faithfully,



Iain Rowson
Associate Partner Regulatory Finance and Governance