

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

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Update on presumed interest rate for Network Innovation Competition (NIC) Projects

We are proposing to consult on a change to the presumed interest rate for NIC projects. The change will reduce the presumed margin over the Bank of England base rate from 1.5 percentage points to 0.5 percentage points.

Background

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. Licensees who are awarded projects receive funds from the system operator. These funds are deposited in to a Project Bank Account.^{1, 2} Licensees must open a Project Bank Account to ensure NIC funding they receive is separate to their normal business accounts.

We³ recently consulted⁴ on the level of interest payments licensees are presumed to receive on deposits in the Project Bank Accounts and the level of interest that licensees actually receive.

The NIC Governance Document expects that the interest received shall be calculated at midyear using the Bank of England base rate plus 1.5 percentage points on 30 June of the year in which the Full Submission⁵ is made. The Governance Document and the submission spreadsheet provide that interest earned by use of this presumed interest rate is subtracted from the funding request. This is because the presumed interest payments should mitigate the resulting shortfall. We have used this calculation to work out the presumed level of interest since the first year of the Low Carbon Networks Fund. However, we chose to consult on the level of interest payments received following feedback from some licensees that external circumstances did not reflect our presumed interest rate.

Summary of responses

We received eight responses to our consultation, all from licensees (with Scottish and Southern Power Distribution (SSEPD) and Scotia Gas Networks (SGN) entering a joint

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

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 "Ofgem", "the Authority", "we" and "us" are used to refer to the Gas and Electricity Markets Authority. Ofgem is the Office of the Authority.

⁴ <https://www.ofgem.gov.uk/publications-and-updates/consultation-presumed-interest-rate-network-innovation-competition-nic-projects>

⁵ The term "Full Submission" has the meaning given to it in the NIC Governance Documents

response). Below we summarise the views expressed for each question. We have not published the three confidential responses.

Question 1: What level of interest would you expect to provide or receive for a large capital deposit made in 2016/17?⁶ Please explain the factors that affect the level of interest provided such as length of deposit and prior knowledge of withdrawals.

All respondents argued that the presumed interest rate provided for within the NIC governance documents was too high (currently 2%, ie the Bank of England Base Rate plus 1.5 percentage points). Most respondents said they had been able to achieve an interest rate of 0.5-1%. However, one licensee stated that it has been able to achieve 1.49% across its portfolio of projects.

Licensees explained that a number of factors affected what level of interest they could expect to receive. These included the type of account, eg lending on the money markets⁷ (lending on the money markets typically results in higher interest rates) or using fixed term notice accounts.

Licensees said that two factors associated with NIC projects limited their ability to use the mechanisms with more generous interest rates:

- the requirements to deposit project funds in a separate bank account or a memorandum account; and
- the way project funding is deposited over the course of the first year of the project and then spent on an ongoing basis.

Some respondents also noted that institutions with more generous interest rates may not have satisfactory credit ratings according to their own corporate governance.

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.

Most respondents commented that they expected a shortfall in project funding as a result of the current presumed interest rate being too high. However, these respondents also expected to be able to address any shortfalls using project contingency funding or as a result of cost savings in other areas. Other respondents stated that it was too early for them to comment on whether there would be any shortfall in project funding.

Decision to consult

We will consult on a proposed change to the relevant NIC governance documents on whether to include a presumed interest rate of 0.5 percentage points above the Bank of England Base Rate for the projects awarded funding through this year's NIC competitions in the relevant governance documents. We explain the reasons for our decision to consult on whether to make these changes below.

Reasons for our decision

In proposing to consult on whether to set the lower presumed level of interest for the 2015 competitions, we will be seeking to strike a balance between: (i) reducing the costs of innovation to gas and electricity customers and (ii) mitigating the risks of a shortfall in

⁶ 2016/17 is the financial year during which funds for successful projects from this year's competition will be deposited in project bank accounts.

⁷ A segment of the financial market in which financial instruments with high liquidity and very short maturities are traded. The money market is used by participants as a means for borrowing and lending in the short term.

project funding for licensees undertaking innovation through the NICs. This is a timely opportunity to consult on this proposed amendment given the changes in interest rates for savings since the beginning of the Low Carbon Networks Fund.

The higher the interest on savings a licensee can achieve, the less money needs to be provided up front by customers. In setting a presumed interest rate above the Bank of England Base Rate, we are incentivising the licensees to achieve a competitive interest rate, providing relative savings to customers.

On the other hand, we do not wish to encourage licensees to make decisions with a higher level of risk with NIC funding than with other regulated revenue streams. As previously noted, licensees commented that some institutions with a lower credit rating offer higher interest rates. We will consult on setting the presumed interest rate at a level that the licensees have been able to achieve with low risk institutions. By consulting on setting the presumed level of interest at 0.5 percentage points above the Bank of England Base Rate we would expect to mitigate the risk of shortfalls in project funding. We will take into account all responses we receive to the consultation and will consider whether this proposed rate is in the interests of consumers and whether it furthers the principal objectives under the Gas Act 1986 and under the Electricity Act 1989. We will then decide whether to proceed with the proposed change.

Finally, should we decide to proceed with the change, in circumstances where licensees receive an interest rate higher than the presumed rate, customers will not be worse off. This is because any funding, including interest payments, left in the project bank account at the end of the project will be returned to customers through the funding return mechanism. Even if more money is deposited in the account as a result of increased interest payments, licensees may only spend money in line with the project direction, which includes funding based on the presumed interest rate.

Next steps

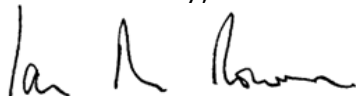
We will consult on changes to the Governance Documents solely to include the proposed level of interest. We intend to issue a decision in response to that consultation in advance of the Full Submission deadline of 31 July 2015. Today we are also issuing the submission spreadsheet to companies that have passed ISP. It includes the functionality for either interest rate (1.5 or 0.5 percentage points above the Bank of England base rate) to be used to calculate the total funding request. The spreadsheet that companies use as part of their Full Submissions should include the interest rate that reflects our decision. If we change the interest rate in the Governance Documents as a result of this consultation this should reduce the likelihood of projects funded this year facing a shortfall in funding.

Enduring solution

We intend to consult on whether to amend the NIC governance documents so that we can advise licensees what interest rate will be used each year. Such an approach is analogous to the setting of the RPI forecast for the licensees to use in their NIC submissions, which we issue in advance of the Full Submissions for each competition. Adopting this method should prevent a similar issue arising in future. We will consult on the detail of this proposal as part of a wider NIC governance review.

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,



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