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Holders of a gas transporter licence, electricity transmission licence, electricity distribution licence, Transport Operators and other interested parties

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Statutory Consultation under section 11A of the Electricity Act 1989 and section 23 of the Gas Act 1986 on the proposed modification to the Funding Return Mechanism (FRM) set out in the Network Innovation Competition (NIC) and Low Carbon Networks Fund (LCNF) licence conditions

Introduction

The NIC and the LCNF were set up to encourage network licensees to innovate in the design, development, and operation of their networks and to engage with third parties in doing so. The NIC and the LCNF, fund a number of large-scale innovation projects.

The FRM set out in the NIC and LCNF licence conditions, is the method by which we can direct money associated with a project, to be returned to customers, (eg if a project is halted early). We propose to make changes to these licence conditions to broaden the use of the FRM – allowing the return of money in cases where the project has delivered more efficiently than expected, or has generated revenue other than through intellectual property. We propose that any generated revenue would be explicitly referenced in the Full Submission, and then in the Project Direction for the project, so that it is clear what funds are subject to the FRM. The mechanism is not intended to be used to return revenue streams identified retrospectively. The proposed changes formalise practices that are already taking place, and provides clarity on the relevant arrangements for new projects.

On 1 March 2016, we issued an informal consultation on the reasons for the proposed licence modification and the necessary licence amendments.¹ This consultation included details of our reasons and impacts of the proposed amendments. A summary of responses to this consultation, and our response to them, can be found in Schedule One below. This consultation focussed on the NIC licence condition, but having considered responses we think it appropriate that the same changes be made to the LCNF condition as well.

Statutory Notices in relation to the proposed changes, are included as subsidiary documents to this letter, on our website. A full list of the affected licensees and licence conditions can be found in Schedule Two. These Notices show our proposed modifications, with new text double underlined.

Please refer to the attached Notices to see the final amendments to the licences. Please note we have shown one amendment to the previously proposed set of licence changes set out under our open letter. This is explained further in this cover letter.

¹ <https://www.ofgem.gov.uk/publications-and-updates/proposed-modification-network-innovation-competition-licence-funding-return-mechanism>

Background

Projects funded by the NIC involve new technologies and the implementation of new operational processes and commercial arrangements. Network licensees compete against each other for a share of the funding. Trials financed through the NIC create knowledge for all licensees, which is made available to all interested parties. This brings potential environmental benefits and cost savings for current and future energy customers.

The NIC licence condition establishes the NIC Funding Mechanism, which enables the relevant licensee to fund Eligible NIC Projects². This is done by means of payments received from National Grid Electricity Transmission plc (NGET) for electricity projects, and from National Grid Gas plc (NGG) for gas projects. The licence condition also establishes the FRM, which enables the Authority to direct the relevant licensee to return money to customers (via NGET or NGG). The LCNF licence condition also establishes a similar mechanism to the FRM, to allow for the return of money to customers. For the purpose of this document, references to the FRM also include this LCNF mechanism.

Proposed changes to the FRM

Currently, the FRM condition allows for money to be returned to customers in certain situations, eg where money has been mis-spent by the Funding Licensee or in relation to returns generated from intellectual property. The specific situations currently provided under the licence condition are:

- Halted Project³
- Disallowed revenue⁴
- Royalty Return⁵

We propose to broaden the scope of the FRM by adding a new category called 'Returned Project Revenues'. This new proposed category covers two areas. It will allow money to be returned to customers:

- should the project be delivered more efficiently than expected, ie there is an underspend on a project, or
- if the project has generated revenue by methods other than through Intellectual Property Rights.

We consider that the proposed changes formalise practices that are already taking place, and support the default position that money should, in the first instance, be returned to customers.

For revenue generated by methods other than through Intellectual Property Rights, there are several ongoing projects that have identified relevant revenue streams that should be returned to parties. The proposed changes would enable this to happen for these projects, as well as for future NIC projects. We propose that any revenues streams that are subject to the FRM would be identifiable in the Project Direction, for both existing and new projects. The mechanism is not intended to be used to return revenue streams identified retrospectively.

The proposed changes also recognise that there may be some limited cases for money to be returned to the Funding Licensee. For example, it could be possible to return some money to the Funding Licensee, where it has made additional financial contributions to the project, (over and above its compulsory contribution), which has meant that the project can take place with a lower amount of NIC funding.

² Capitalised terms not otherwise defined in this letter have the meaning given to them in the NIC Licence condition and in the NIC Governance Document.

³ When Ofgem directs a Project to be halted, any unspent money must be returned to customers.

⁴ When Ofgem assesses that money spent has not been in accordance with the Project Direction, the network company must return that money to consumers from its own budgets.

⁵ When a Project has received money from intellectual property which it has because of a NIC funded Project, then some of the money must be returned to customers.

Changes to the position in our March consultation

We received nine responses to our March consultation. These responses have been published on our website.⁶ All responses were supportive of the proposed changes. Some minor changes and points of clarification, specifically in relation to the working of this mechanism, were suggested. Schedule One to this letter, sets out the points raised and our response. Changes made as a result of responses has been reflected in the proposed licence drafting.

One significant change in response to the comments received, is to include the proposed amendments in the existing LCNF licence condition (CRC 2J). This condition applies to electricity Distribution Network Operators (DNOs). The inclusion of this licence condition ensures that existing LCNF projects can also benefit from these changes. Therefore, an amended version of this licence condition has been included with the DNO Notice.

One other change is to clarify within the licence drafting that we will only direct money to be returned to customers or to the Funding Licensee - not to other parties. This change is partially in response to several of the consultation responses. We consider it important that the Funding Licensee can return money to other parties involved in the Eligible NIC Project where appropriate, but don't consider this to be a matter for Ofgem to decide. The default in all cases is that money unspent (and revenues earned) should go back to customers, since they provide the bulk of funding that makes these projects possible.

Reasons for the proposed change

There are two reasons for the proposed licence changes.

Reason 1: We think it is important that the FRM is capable of returning money to customers, where the Funding Licensee has spent less than the project budget, but has acted in line with the Project Direction. This is currently not provided for as part of the NIC or LCNF licence conditions. We also think there could be occasions where the Authority thinks it is appropriate for underspent NIC/LCNF money to be returned to the Funding Licensee, not just customers, and the proposed changes allow for this.

Reason 2: In recent NIC competitions, licensees have included innovative ways of generating money (that is not through intellectual property), from their relevant projects that will be returned to customers. For example, the City CNG⁷ project aims to pay back the connection costs of a compressed natural gas (CNG) filling station, (funded by the NIC), to customers based on usage of the filling station. We think that this enhances the value of the project for customers. We welcome this type of innovative thinking and would like to encourage it. Such arrangements are not currently provided for in the relevant NIC licence condition. Formalising this approach under the licence provides certainty for current LCNF and NIC projects that have identified such revenue streams. It also provides clarity for future NIC projects.

Specifically, the new 'Returned Project Revenues' provision, introduces the ability to return money generated by the project, that is not intellectual property. The money is expected to be returned to customers, however if we think it is appropriate, there is the opportunity for the Funding Licensee to retain a proportion, if it can provide adequate justification that this is in the interest of customers. Any revenues earned that are subject to this mechanism should be identifiable in the Project Direction. For new NIC projects, it is for the licensee in its Full Submission, to identify any revenues that could be earned from its project that

⁶ <https://www.ofgem.gov.uk/publications-and-updates/proposed-modification-network-innovation-competition-licence-funding-return-mechanism>

⁷ <https://www.ofgem.gov.uk/publications-and-updates/network-innovation-competition-2015-northern-gas-networks-decision-resubmission>

should be subject to return. For projects already in force that have identified in their Full Submission potential sources of revenue to be returned, we will need to amend the Project Direction to recognise this revenue source. The mechanism is not intended to be used to return revenue streams identified retrospectively.

The effect of the proposed modifications is to:

- enable the return of NIC and LCNF funding during or at the end of a project, where the project has underspent its budget but where the Funding Licensee has acted in line with the Project Direction
- allow the return of revenue generated by the project, other than through Intellectual Property,
- allow the Authority to direct whether money should be retained by customers and/or the Funding Licensee.

Next Steps

We have today issued Notices under section 11A(2) of the Electricity Act 1989 and under section 23(2) of the Gas Act 1986 to the relevant licence holders. The proposed drafting can be found in the relevant Statutory Notices appended to this letter (see subsidiary documents on our website).

Representations on the proposed modifications must be made on, or before, 25 October 2016.

Please submit responses by email to Stacy Feldmann: stacy.feldmann@ofgem.gov.uk. Unless clearly marked as confidential, all responses will be published on our website. Ofgem shall respect requests to keep a submission confidential, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

Following this consultation, if we decide to make the licence changes, we intend to modify the relevant governance documents to provide further clarity on the workings of this mechanism. Later this year, the NIC Governance Documents are expected to be reviewed and modified as part of our separate governance review of the NIC and NIA.⁸ As part of this review, we intend to include modifications to the governance documents that will reflect the working of this proposed mechanism.

Geoff Randall

Head of RIIO, Electricity Transmission

⁸ <https://www.ofgem.gov.uk/publications-and-updates/reviewing-benefits-low-carbon-networks-fund-and-governance-network-innovation-competition-and-network-innovation-allowance>

Schedule One: Summary of responses to our 1st March consultation

Respondent	Summary of comments	Ofgem response
Northern Powergrid (NPg), Electricity Northwest Ltd (ENWL), and Western Power Distribution (WPD)	Supportive of the proposals	Noted
British Gas	<p>Support the return of revenue generated from any additional income stream because customers are required to fund the projects.</p> <p>Recommends:</p> <ul style="list-style-type: none"> i. DNOs should not be permitted to earn additional 'unregulated' revenue from projects deployed to avoid transmission Triads. ii. The approach to Returned Royalty Income is adopted for Returned Project Revenues. Customers currently benefit from profits generated by intellectual property rights, as set out in the respective NIC Licence conditions and Governance documents. In particular, no limitation has been placed on the period over which customers will share these profits. Clarification should be provided on the time period for recovery. iii. The terms 'revenues earned' and 'relevant revenues' in proposed clauses 31.15 b) and c) respectively should be defined. 	<ul style="list-style-type: none"> i. We acknowledge the concern related to potential double-counting of benefits, by making customers pay both for avoidance of triads and for projects where triad avoidance may be the focus of the project. We intend to ensure that all relevant Project Directions allow any revenue earned to be returned to relevant parties. Our default view is that any revenues earned should be returned to customers and it would be for network licensees to justify any deviation from this. ii. With regard to the time limit for the recovery of funds, we agree that the same approach is applied as for Returned Royalty Income, i.e. the default position being no limitation on the period over which customers will share in these profits. Should a licensee require alternative arrangements, we would consider these, and if justified, reflect it in the Project Direction. We will clarify this point in the governance document. iii. We wish to encourage some flexibility in how licensees approach the ability to generate returns for the benefit of customers and do not consider it necessary to define these terms. <p>Any revenues earned that are subject to this mechanism should be identifiable in the Project Direction. For new NIC projects, it is for the licensee, in their Full Submission, to identify any revenues that could be earned from their</p>

		<p>Project and, if appropriate, justify if these should be retained by the Funding Licensee. As noted in our March consultation, such arrangements would then be reflected in the Project Direction. The default position is for money to be returned to customers.</p> <p>For Projects that are already in force that have identified sources of revenue to return to customers (or the Funding Licensee) in their Full Submission, eg NGET's OSEAIT project, we will need to amend the Project Direction to recognise this revenue source.</p> <p>We will look to reflect these points in the relevant governance documents.</p>
National Grid	<p>National Grid agrees in principle to the proposed changes but had the following comments:</p> <ul style="list-style-type: none"> i. 'revenue earned' and 'relevant revenues' should be defined. It will be particularly important for project partners ensure that this excludes revenue earned by them. The interaction between background IPR, foreground IPR and future developments outside of NIC mechanisms could all impact on the 'relevant revenues' and the identification of which revenues are deemed directly attributable could be complex. ii. The licensees and Ofgem should identify relevant revenues that are clearly foreseeable at the time of the NIC bid evaluation. The initial Project Direction from the Authority should set out the nature of any proposed arrangements for the treatment of clearly foreseeable revenues. An ex-post treatment of relevant revenues would create additional uncertainty and deter innovation that could otherwise be of great value to consumers. We suggest that an industry workshop to discuss examples and options for the Funding Return methodology would be very useful before any changes are made to the licence. iii. The return of unspent NIC funding has a natural 	<ul style="list-style-type: none"> i. See our response to British Gas above in point (iii). ii. See our response to British Gas above in point (iii). iii. See our response to British Gas above, point (ii).

	<p>limit, as it will never exceed the amount of NIC funding. Consideration should be given to the amount of relevant revenue and the appropriate time period over which relevant revenues are returned so that consumers continue to benefit most from NIC projects aimed at.</p>	
Northern Gas Networks (NGN)	Note that paragraph 1I.11(c) is not part of the definition of Return Project Revenues and should be a separate paragraph.	This has been updated in the attached licence drafting changes.
SP Energy Networks (SPEN)	<p>SPEN is supportive in principle-but thinks the mechanism should incentivise outperformance. It had the following comments:</p> <ul style="list-style-type: none"> • NIC funding currently does not flow through the TOTEX incentive mechanism like other incentives. The TOTEX incentive mechanism should be replicated for NIC and NIA to allow for outperformance to be incentivised. • Underspends should be shared with customers with through the appropriate TOTEX incentive strength rate. • It would be useful to engage informally with TOs and DNOs to try to arrive at a good method to effectively share underspends and incentivise outperformance. 	We appreciate SPEN’s suggestion. At this stage, the consideration of moving NIC and NIA to a TOTEX approach is a substantial one and outside the scope of this project to amend the FRM. It should however be noted, that under this new mechanism, sharing of any Project underspend and/or revenue earned amongst other parties may be considered by us. We will look to re-iterate this point in the Governance Documents.
Scottish and Southern Energy Power Distribution (SSEPD)	<p>SSEPD is supportive of the proposals, but had the following clarification points:</p> <ol style="list-style-type: none"> i. It needs to be clear what part of underspend is returned to customers vs what would be returned to third parties. ii. For revenue generation the modifications suggest that the Authority may determine the revenues that are payable to customers, returned to the licensee or distributed to other partners. SSE considers the Authority in conjunction with the responsible licensee makes an informed decision of how to best allocate revenues earned. For revenues earned during the 	<ol style="list-style-type: none"> i. The default is for money to be returned to customers. The proposed condition allows for money to be returned to the licensee where appropriate – we propose to set out further guidance in the governance document on the cases where we might return money to the licensee. ii. See our response to National Grid point (ii). It is for the network licensee to make the case, which will then be reflected in the Project Direction as appropriate.

	<p>funding period it suggests that these remain with the project and are reinvested to incentivise greater innovation.</p>	
<p>UK Power Networks Ltd (UKPN)</p>	<p>UKPN is broadly supportive of the proposals but raised two concerns:</p> <ul style="list-style-type: none"> i. For consistency, Ofgem should extend these amendments to include the LCNF Tier 2 mechanism ii. On CRC5A.11(c) of the DNO condition we believe that the mechanism by which a licensee can propose to retain some of the revenue should be documented. At the moment this is unclear and its inclusion would provide clarity for all parties, be they licensees or not. 	<ul style="list-style-type: none"> i. We agree. The notices now reflect the relevant changes to the LCNF licence condition, for DNO consideration. ii. See our response to SSE at point (ii)

Schedule Two: List of affected licence conditions and licensees

Each Statutory consultation has been published as a subsidiary document to this consultation.

Licensees affected	Licence condition number
NGET	Special Condition 3I. The Network Innovation Competition Special Condition 1A. Definitions and Interpretation
Electricity Transmission Owner	Special Condition 3I. The Network Innovation Competition Special Condition 1A (Definitions and Interpretation)
Distribution Network Operator	Special Condition CRC 5A. The Network Innovation Competition CRC 2J, Low Carbon Networks Fund
Offshore Transmission Owner	Amended Standard Condition E12-J11: The Network Innovation Amended Standard Condition E12 – A1: Definitions and Interpretation
NGG	Special Condition 2F. The Network Innovation Competition Special Condition 1A. Definitions
Gas Distribution Networks	Special Condition 1I. The Network Innovation Competition Special Condition 1A. Restriction of revenue in respect of the Distribution Network Transportation Activity: definitions
Independent Gas Transporters	Special Condition 2 of GTC's licence ⁹

⁹ We will publish a separate consultation to insert the NIC licence condition in to the licences of all other iGTs and the electricity independent distribution network operators.