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Decision to modify the Funding Return Mechanism (FRM) set out in the Network Innovation Competition (NIC) and Low Carbon Networks Fund (LCNF) licence conditions

Overview

The NIC and the LCNF (for electricity distribution networks only), were set up to encourage network companies to innovate in the design, development, and operation of their networks and to engage with third parties in doing so.

The FRM set out in the NIC licence condition, is the method by which we can direct money associated with a project, to be returned to customers. The LCNF licence condition also establishes a similar mechanism to the FRM. For the purpose of this document, references to the FRM also include this LCNF mechanism.

In March 2016¹, we consulted on our proposals to make changes to the NIC and LCNF 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. This was followed by a statutory licence consultation, published in September 2016². This letter sets out our decision to modify the NIC and LCNF licence conditions following the statutory consultation, and provides our response to stakeholders' comments. Accompanying this letter are Notices containing the final licence changes which we are making.

Our decision

Following our statutory consultation, we have decided to modify the relevant distribution and transmission NIC and LCNF licence conditions, to broaden the use of the FRM. We have made some minor changes to the versions of the licence that we issued as part of the statutory consultation. The reasons for these changes are set out below.

Change 1: In our statutory consultation, we clarified that the licence changes should only allow us to direct money to be returned to customers or to the Funding Licensee - not to other parties³. The change was partially in response to several of the consultation responses. This does not preclude the Funding Licensee returning money to other parties

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

² <https://www.ofgem.gov.uk/publications-and-updates/proposed-modification-funding-return-mechanism-network-innovation-competition-and-low-carbon-networks-fund-licence-conditions>

³ See page 3 'Changes to the position in our March consultation': <https://www.ofgem.gov.uk/publications-and-updates/proposed-modification-funding-return-mechanism-network-innovation-competition-and-low-carbon-networks-fund-licence-conditions>

involved in the Eligible NIC Project, but we don't consider this to be a matter for Ofgem to decide. The default in all cases is that money should go back to customers, since they provide the bulk of funding that makes these projects possible. This change to the licence was reflected in the statutory consultation notices for electricity distribution and electricity transmission (Scottish transmission owners). In error, the change was not reflected in the other Notices published at statutory consultation stage despite the intention to do so having been made clear in the statutory consultation. For the avoidance of doubt, we intended the change to be made across all the Notices⁴.

Change 2: The changes we are making add new paragraphs in to the NIC licence condition. This has a consequential effect on the paragraph numbers and referencing used throughout the licence condition. In the statutory consultation we only showed the consequential effects on the relevant part of the condition. We now show all the minor referencing changes that are required in the NIC licence condition. This affects all the Notices.

For OFTO licensees only, we also note that Amended Standard Condition E12-J11 the Gwynt y Môr OFTO plc licence is marginally different to the licences of the other offshore electricity transmission licensees. The difference is not a result of the changes in this decision.⁵ We have therefore made clear in the OFTO Notice which version of the licence applies to Gwynt y Môr and which applies to the other licensees.

No other changes have been made to the licence conditions beyond those that we consulted on in September.

We received six responses to our statutory licence consultation, one that is confidential (but was supportive of the changes).⁶ All non-confidential responses are summarised in Schedule 1 of this letter - where we have also responded to the issues raised. Schedule 2 provides a full list of affected licensees and relevant licence conditions where the modifications have been made.

Some responses requested further clarity on how the changes will work in practice in the accompanying NIC and LCNF guidance documents. We agree, and proposed changes to governance documents will be consulted on shortly and (subject to consultation responses), implemented as part of our Innovation Review.

The reasons and effects for our decision are set out in the Notices accompanying this letter, as published on our website. In summary:

1. We think it is important that the FRM is capable of returning money to customers, where the Funding Licensee⁷ 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 changes being made allow for this.
2. In recent NIC competitions, licensees have included innovative ways of generating money (that is not through intellectual property), from their relevant projects that

⁴ The change has now been clearly marked with a strikethrough in the: Gas Distribution Network Notice (Special Condition 1I.12), Independent Gas Distribution Network (GTC) Notice (Special Condition 2, paragraph 12), National Grid Electricity Transmission Notice (Special Condition 3I.16), National Grid Gas plc Notice (Special Condition 2F.16), and Offshore Electricity Transmission Notice (Amended Standard Condition E12-J11, paragraph 12).

⁵ Paragraphs 19(d) and 21 (previously paragraphs 17 and 19) in the Gwynt y Môr licence do not contain the words "and electricity Distribution Licensees".

⁶ The non-confidential responses have been published alongside this letter.

⁷ The term 'Funding Licensee' has the meaning given to it in the NIC and LCNF governance documents.

will be returned to customers. 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 generated through 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. 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 should be subject to return. For existing NIC projects 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.

We have today issued Notices of our decision to modify relevant licences under section 11A(2) of the Electricity Act 1989 and under section 23(2) of the Gas Act 1986. The Notices are published alongside this letter on our website.

Should you have any questions, please contact, Thomas Mackenzie,
Thomas.Mackenzie@ofgem.gov.uk.

Yours faithfully,



Geoff Randall
Head of RIIO Electricity Transmission

Schedule 1: Summary of responses received to our statutory licence consultation

Respondent	Summary	Our response
Electricity North West Ltd (ENWL)	<p>ENWL note our response to a comment from British Gas (BG) – set out in schedule 1 of our statutory consultation. For ease this is summarised below.</p> <p>BG queried the time limit associated with the return of funds generated under the new 'Returned Project Revenues' category. BG advocated that this new category should mirror the approach to the time limit for returning funds for 'Returned Royalty Income'.</p> <p>In our response to BG, we agreed that the time limit should align with the approach taken for 'Returned Royalty Income' - ie that there is no time limit in which customers could receive funds generated by an Eligible NIC Project.</p> <p>ENWL raised concerns about the ambiguity of our response and are concerned it could be interpreted to mean that income associated with the business as usual rollout of the successful innovation, after project close, could also be subject to the 'Returned Project Revenues' provision.</p>	<p>As indicated in our September statutory consultation, revenues generated under a project, that are subject to the 'Returned Project Revenues' provision, should be signalled in the Full Submission and must be identified within the Project Direction. As such it should be clear to the network company when this mechanism will be used for a particular project and the timescales for its operation. Again, for the avoidance of doubt, this mechanism is not intended to be used on a revenue stream identified retrospectively.</p> <p>While we consider that the default should be no time limit in which customers could receive funds generated by an Eligible NIC Project, the Funding Licensee can make the case for an alternative payback timescale for an identified revenue stream. This would then be reflected in the Project Direction (as noted in our response to comments in our statutory consultation). Therefore in some cases the payback period could align with the completion date of the Eligible NIC project.</p> <p>We already have one NIC project (City CNG) generating 'Returned Project Revenues' that will continue beyond the project completion date.</p> <p>The NIC and LCNF governance documents will clarify that the Project Direction will contain the details of the relevant revenue stream and (where relevant) the payback timescale. We will consult on these changes as part of our Innovation Review.</p>
National Grid Electricity Transmission (NGET)	Support Ofgem's proposal to clarify that the FRM should be captured in the Project Direction at the outset of a project and that it will not be applied retrospectively.	Noted

National Grid Gas Transmission (NGG)	Supportive of proposals with no specific comments	Noted
UK Power Networks	Supportive, but requested clarity, that the mechanism only operates during the life of a relevant project; ie only applies to revenue earned up to project completion date. If this is not the intention - would welcome some discussion.	Please see our response to ENWL above. In particular, there are instances where revenues generated, beyond the project completion date, have been identified as relevant revenue earned.
Scottish and Southern Energy	Supportive, but believe further clarity is required in relation to ongoing projects, where there is an expectation of revenues being earned. Their expectation is for greater clarity in the LCNF and NIC guidance documents.	<p>In our statutory consultation, we noted that for existing projects that are generating eligible revenue, the Project Directions would need to be updated to signal this revenue source. Any existing projects eligible for the new provisions under the FRM, should liaise with their Ofgem project officers to make changes to the Project Directions. We do not envisage that there are a lot of projects that have identified such revenue streams to date.</p> <p>We will also be consulting on changes to the NIC and LCNF governance documents as part of our Innovation Review.</p>

Schedule 2: List of affected licence conditions and licensees

Each Notice has been published as a subsidiary document to this letter.

Licensees affected	Licence condition number
NGET	Special Condition 3I. The Network Innovation Competition Special Condition 1A. (Definitions and Interpretation)
Electricity Transmission Owners	Special Condition 3I. The Network Innovation Competition Special Condition 1A. (Definitions and Interpretation)
Distribution Network Operators	Special Condition CRC 5A. The Network Innovation Competition CRC 2J. Low Carbon Networks Fund
Offshore Transmission Owners	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 (iGTs)	Special Condition 2 of GTC's licence ⁸

⁸ 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.