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To all interested parties

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IFA Use of Revenue framework

Today Ofgem is publishing statutory consultations introducing changes to the licences of National Grid Electricity Transmission and National Grid Interconnectors Ltd (NGIC)[1] to enable money to be returned to consumers by IFA[2] via Transmission Network Use of System charges. Ofgem has reached agreement with National Grid on an appropriate framework to enable Ofgem to agree IFA's Use of Revenues statements and the amount of money to be returned to consumers. This note describes that framework.

The IFA interconnector is jointly owned by National Grid and RTE. It was built pre-privatisation 30 years ago. The link has brought a big benefit to consumers as it has imported cheaper electricity from the continent. This has contributed to lower GB wholesale prices. Ofgem recognises the benefits of maintaining the availability and reliability of this interconnector which has been in service for approximately 30 years. Accordingly we have provided sufficient incentive for National Grid to use every endeavour to ensure maximum continuing availability.

At the same time we have provided for revenues over and above the incentive level to be paid to consumers, while National Grid are embarking on a major programme to build additional interconnectors.

This agreement ensures that the financial future of the interconnector is secured, investors are properly rewarded for their investment, and surplus funds are returned to consumers and other network users.

Further details of these arrangements are given in Annex 1.

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[1] https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-changes-standard-conditions-electricity-interconnector-licence-electricity-interconnector-licences-held-nemo-link-and-ngil-and-electricity-transmission-licence-held-nget

[2] 'Interconnexion France-Angleterre', the interconnector between England and France

Annex 1: IFA Use of Revenue framework

1. Introduction: the requirement

1.1 Licence Condition 9(5)(c) of the Interconnector Licence held by National Grid Interconnector Limited ('NGIC') in respect of Interconnexion France-Angleterre ('IFA') requires that NGIC provide an annual statement verifying that, in the licensee's view, the actual use of revenues resulting from the allocation of interconnection is in accordance with Article 16(6) of the Regulation (EC) No 714/2009, and giving reasons for that view.

2. Cumulative Cashflow Model

2.1 Given the regulatory history of IFA an appropriate framework has been developed by NGIC and Ofgem to ensure NGIC's revenues will be sufficient to maximise the ongoing availability and reliability of IFA, while also facilitating the appropriate compliance with Article 16(6).

- This framework takes as its starting point (i) the capital expenditure to construct IFA, (ii) IFA's annual revenues and (iii) ongoing opex and repex.
- The objective of this framework is to (i) identify the point at which a target rate of return on the investment has been achieved, and then (ii) allocate future cashflows (net of opex and further capex/repex) from that point between NGIC and consumers.

A Cumulative Cashflow Model has been used. The steps are:

- For any given year (starting with 1 April 1990, the date of IFA's privatisation), capex, repex and opex are deducted from total revenue; this gives an annual net cashflow figure for each year (to date) of the asset.
- These cashflows are discounted to provide an NPV for any given year.
- Doing this on an annual basis identifies the year at which the NPV of the project is zero (i.e. "NPV neutrality")
- After this point – i.e. the point at which the project has achieved a baseline return – any positive cashflows are shared between:
    - NGIC to ensure ongoing reliable performance of the interconnector
    - the consumer
    - in certain circumstances, retained in a separate line account
- In periods of heavy expenditure net cashflows may turn negative and distribution of net cash as above will be suspended until the project NPV returns to positive.

2.2 It is not envisaged that the Cumulative Cashflow Model will be amended in the future except for the annual input of IFA's cashflows and the inflation index.

2.3 Figure 1 below illustrates the main building blocks of the framework and the sections below provide further details.

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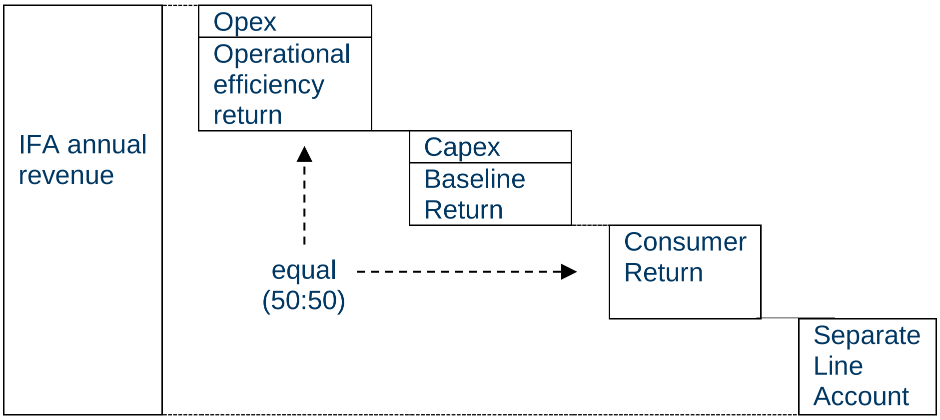
Figure 1: Four components of revenue use



(1) Guaranteeing the actual availability of the allocated capacity

2.4 When the Cumulative Cashflow Model calculates IFA's baseline return to be zero, NGIC continues to be incentivised to guarantee the actual availability of the allocated capacity on IFA in an efficient manner. This is achieved through sharing operational cashflows between NGIC and consumers, with the share allocated to NGIC being an operational efficiency payment. The sharing factor applied to IFA's operational cashflows will be 50% of the total – that is, there will be an equal division between consumers and NGIC. This will be phased in over an initial period.

(2) Maintaining or increasing interconnection capacities

2.5 TSOs earn an appropriate return to ensure that future revenues are sufficient to support the ongoing reliability of the interconnector, given the inherent volatility of revenues and costs year on year, and to provide a signal to its shareholders to continue to make investments in other interconnection assets.

2.6 When the baseline return earned by NGIC is calculated to be equal to the appropriate return, no further baseline return will be recovered by NGIC.

2.7 The Cumulative Cashflow Model calculates that NPV neutrality is achieved at the beginning of the 2016/17 financial year (i.e. IFA is considered to have reached NPV neutrality on 31 March 2016).

(3) Income to be taken into account when calculating network tariffs

2.8 NGIC will request to Ofgem that after NPV neutrality has been reached, a portion of operational cashflows will be payable to consumers, via network tariffs. The proportion of operational cashflows will be set by the sharing factor which is documented above.

(4) Separate Internal Line Account ('SLA')

2.9 There may be situations where NGIC expects negative net cashflows in the future as a result of expenditures made guaranteeing availability and maintaining or increasing interconnection capacity. These can be funded from a cash reserve account – the SLA – which would be built from current cashflows. NGIC will monitor future net cashflows from IFA and if it considers that funds need to be placed in a SLA, it may propose this course of action to Ofgem. Any such allocation to a SLA will be subject to approval by Ofgem in accordance with the Licence.

2.10 NGIC does not currently anticipate negative future cashflows in current business plan forecasts. However, the SLA may be an appropriate mechanism to anticipate decommissioning costs since those costs incurred by NGIC cannot be recouped by any future cashflows.

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3. Summary

3.1 The Cumulative Cashflow Model facilitates appropriate compliance with the requirements of Article 16(6) by demonstrating that revenues have been used efficiently to guarantee the actual availability of IFA capacity and to maintain that capacity through ongoing and future investment in IFA. It also includes provisions to share revenues with consumers and an option to fund a SLA where necessary

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