

To those with an interest in
innovation in energy networks



Making a positive difference
for energy consumers

Direct Dial: 020 7901 7159
Email: andrew.burgess@ofgem.gov.uk

Date: 17 December 2015

Reviewing the benefits of the Low Carbon Networks Fund and the governance of the Network Innovation Competition and the Network Innovation Allowance

In regulating energy networks and the system operator, we¹ promote innovation which brings benefits and value for money for consumers. This letter seeks your views on the governance of some of our innovation funding mechanisms for electricity and gas and the level of funding that should be available in the electricity Network Innovation Competition (NIC) for the remainder of the electricity distribution price control period.

We committed to carrying out a post implementation review of the governance arrangements for the Network Innovation Allowance (NIA) and the NIC once they had been in operation for two years. We also said we would review the benefits of the Low Carbon Network (LCN) Fund after five years and set the level of funding available under the electricity NIC from 2017 until the end of the electricity distribution price control period in 2023.

This letter begins both these processes. We are starting by calling for views on the two reviews together because they involve overlapping policy questions. We are also going to commission an independent evaluation of the LCN Fund. This will inform the decisions we have to make. We will share responses to this letter with the independent evaluator when they have been appointed.

These reviews provide an opportunity to examine the governance arrangements, including the criteria we use to evaluate NIC competitions and whether the process of awarding funding could be improved.

We want to hear views on any aspects of the mechanisms. This includes the experiences of third parties partnering with network licensees and those seeking to partner with them about whether that process can be improved. We also want to understand whether the innovation funding is changing the distribution network operators' (DNOs') approach to managing their networks. This includes whether innovative, flexible solutions are a core part of the DNOs' business if they provide the most cost effective solution for the network. We want to know whether we can improve participation by DNOs (and by extension other types of network) and the quality of their proposals (for example by providing guidance on the types of areas innovation could focus on such as whole system solutions and flexibility services).

¹ The terms "the Authority", "Ofgem", "we", "us" and "our" are used interchangeably in this letter. The Authority is the gas and electricity markets authority. Ofgem is the office of the Authority.

In this letter we set out the way forward and next steps. In appendix 1 we describe the background to the innovation mechanisms, our plans for appointing an independent expert to evaluate the Low Carbon Network (LCN) Fund and some issues associated with the NIC and NIA governance arrangements. We welcome comments on any aspect of the two reviews but we have included detailed questions in appendix 1.

Way Forward

Once we have received responses to this consultation we will review all responses and share these with the independent expert(s) appointed to carry out the evaluation. We will also publish all responses unless they are marked confidential. We expect the independent evaluation to be completed by summer next year. We will use the responses to this consultation and outcome of the evaluation to develop our proposals for the level of electricity NIC funding going forward and the governance of the NIC and NIA. We will consult on our proposals by autumn next year.

We may also consult on small changes to the NIC and NIA governance documents by April 2016.

Next Steps

We welcome responses to the issues we have raised in this letter by **5 February 2016**. Responses should be sent, preferably by email, to networks.innovation@ofgem.gov.uk or in writing to:

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

If you wish to have your response remain confidential, please clearly mark the document to that effect. Unless marked confidential, all responses will be published on our website.

If 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,



Andrew Burgess
Associate Partner, Smarter Grids and Governance

Appendix 1

Background

Licensees² are incentivised to innovate through the price control framework which dictates how much licensees can recover in charges from customers. We regulate companies using our Revenue = Incentives + Innovation + Outputs (RIIO) framework.³ When we established this framework we recognised licensees need to innovate to address the challenges they face, such as intermittent generation and a constrained network. In addition to incentives core to the price control framework, such as the sharing mechanism which means customers and licensees both benefit from any cost savings, we also included a time limited innovation stimulus. This consists of:

- the NIA – an allowance licensees receive as part of their price control revenues to fund small scale innovation projects;
- NIC – funding for large scale development and demonstration projects, made available following a competitive process each year; and
- the Innovation Roll-out Mechanism (IRM) – funding for the rollout of successful innovations where the existing price control will not fund it.

When we introduced the innovation stimulus we said it would be time limited as we wanted licensees to develop a culture of innovation. Over time we expect the RIIO framework incentives will encourage licensees to innovate without specific funding for 'innovation'.

The LCN Fund provided similar funding to the NIC and NIA for innovation projects by distribution network operators (DNOs) from 2010-11 to 2014-15 and was in many ways the precursor to the RIIO mechanisms.

The table below illustrates the amount available under each NIC each year until 2021. The output of the benefits review will confirm how much funding is available under the electricity NIC from 2017 until the end of the RIIO-ED1 period in 2023.

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Gas NIC	£20m	£20m	£20m	£20m	£20m	£20m	£20m	£20m
Electricity NIC	£30m	£30m	£90m	£90m	At least £30m ⁴ tbc	At least £30m tbc	At least £30m tbc	At least £30m tbc

The level of gas NIC funding is outside the scope of this review as we have confirmed the level of funding available under the gas NIC until the end of the price control period.

Independent Evaluation of the LCN Fund

The LCN Fund was intended to fund trials of new technologies, systems, commercial and network operating arrangements. Projects were intended to have third party involvement to broaden the thinking in the sector. Without this funding we considered there was a risk that DNOs would inhibit the transition to a low carbon economy. We also wanted licensees to make innovation a core part of their business. The incentive we introduced in DPCR5 has subsequently been translated into the Network Innovation Competitions in the four RIIO eight year price controls. We intend to appoint an independent expert or experts to evaluate the effectiveness of the LCN Fund in delivering our original intent.

² For the purposes of this letter licensees include gas and electricity transmission companies (including offshore transmission owners) and gas and electricity distribution companies

³ While the NIC has been established under the RIIO framework all network licensees are eligible to participate in the NIC, not just licensees who are regulated through a RIIO price control.

⁴ Transmission element established in RIIO T1

Review of the NIC and NIA governance arrangements

NIC and NIA Governance Arrangements

The NIC⁵ and NIA⁶ Governance Documents set out the regulation and administration of the NIC and NIA and supplement the relevant licence conditions in regulating them. We said we would review these arrangements once they had been in place for two years. The Governance Documents came into force on 1 April 2013 for all licensees apart from electricity distributors who were able to make use of the NIC and NIA from 1 April 2015.

The Governance Documents include the relevant criteria with which NIC and NIA projects must comply. They also set out the various processes associated with the NIC and NIA.

NIC and NIA Criteria

The criteria of the NIC and NIA set out what types of projects licensees can implement, for example NIC projects must deliver carbon and/or environmental benefits as well as financial benefits to customers.

We will consider whether we should amend them. We would like to know whether the existing criteria incentivise licensees to innovate to the fullest extent possible. We would also like to understand whether you feel we should provide guidance in regards to the subjects projects could focus on, eg flexibility or smart technologies.

We are also seeking views on the types of benefits you consider we should take into account when awarding funding. Projects may deliver benefits to both customers of the network and also to other elements of the system, or to other sectors of the energy market. For example, a gas project could deliver benefits to electricity customers. While we currently consider these benefits in our assessment, we would normally expect that if significant benefits accrue to someone other than the network's customers, for example a supplier, that entity should make a proportionate contribution to the project.

Question 1: Should we change the NIC and NIA criteria? If so how and why?

Question 2: Should we give more of an indication of where we consider innovation is required or is that inappropriate?

Question 3: Should the focus of the NIC and NIA be broader and cover the broader energy system?

The process for approving NIC projects

We award NIC funding using a competitive process. Licensees submit projects for funding. We screen submissions early in the process to ensure only projects that are eligible for funding go forward to the full submission stage. At this point we consider which projects perform best against the evaluation criteria in the Governance Document. A decision is taken in the round based on the projects we have received and how they perform against the evaluation criteria.

The NIC Expert Panels advise us on which projects should be awarded funding. The Panels bring knowledge and expertise covering energy network industries, environmental policy, technical and engineering issues, economics and finance, and consumer interests. The Expert Panels make recommendations on which projects should be awarded funding. We take these recommendations into account when we make our decision on whether to award funding.

⁵ <https://www.ofgem.gov.uk/publications-and-updates/version-2-1-network-innovation-competition-governance-documents>

⁶ <https://www.ofgem.gov.uk/publications-and-updates/version-two-network-innovation-allowance-nia-governance-documents>

The Panels' recommendations are not binding on us but we have not, to date, disagreed with the Panel's advice.

Question 4: Can we improve the process for deciding on which projects to approve and if so how?

Participation in the NIC

Under the current arrangements only licensees can seek funding from the competition. Third parties must partner with a licensee in order to be eligible for funding. However, we recognise this may limit the number and range of submissions we receive each year. Notwithstanding any necessary legislative changes which may be required in order to allow non-licensees to participate, and without fettering our discretion on whether to propose these (the decision on whether to make those legislative changes would be made by DECC), we would like to know whether there is in principle an appetite among possible third party participants to compete for funding directly, without a licensee partner.

Related to the point above, we would also like to find out about non-network companies' experiences of working with licensees in NIC projects and as innovations become business as usual. We would like stakeholders to share their experiences with us.

Question 5: How can we improve participation in the NIC?

Question 6: Please comment on your experiences if you have worked with licensees when implementing NIC and NIA projects or when transferring innovation into business as usual.

Other issues

We are aware that stakeholders may think other issues should be considered as part of the review.

Question 7: Are there any other issues we and the independent evaluator should consider as part of the review?

Review of LCN Fund Benefits

As part of the LCN Fund benefits review we will consider whether the innovation undertaken by DNOs under the LCN Fund has delivered value for money for customers, whether DNOs have maximised these benefits by using the learning from these trials in their core business, how they have demonstrated this and whether DNOs can demonstrate that there is shared learning across all of the projects.

In setting the level of NIC funding we will consider whether DNOs still need to be incentivised to innovate and whether the current level of funding should be maintained. This includes considering whether innovation is now core to the way the DNOs operate. It is also important to understand what further scope there is for DNOs to innovate in the way they have during the last price control period.

Question 8: To what extent do you consider that the LCN Fund has succeeded?

Question 9: To what extent do we need to continue incentivising innovation by DNOs?

Question 10: Are there any other issues we need to consider as part of the LCN Fund benefits review?