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Gareth Evans
Technical Directorate
Office of Gas and Electricity Markets
9 Millbank
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Dear Mr Evans

Innovation and Registered Power Zones

Please find enclosed Aquila's response to Ofgem's Innovation and Registered Power Zones Discussion Paper, July 2003 regarding the possible regulatory instruments that could be applied to Innovation and Registered Power Zones. The proposed increase in the amount of generation connected to distribution networks during DPCR 4 is likely to lead to the requirement for Distribution Network Owners (DNOs) to become more innovative when considering future network development. We therefore welcome Ofgem's thoughts of how to manage and reward this innovation. However, we do believe that a clear and concise framework is required, along with significant incentives if the industry is to actively invest in innovation. Our thoughts on the points set out in the paper follow.

Innovation Funding Incentive (IFI)

As highlighted in the paper, the current level of Research and Development spend by Distribution Network Owners (DNOs) is very low when compared with other areas of the energy market and other industries. We agree and in order to meet the Government's targets for renewable energy and CO₂ emissions there will have to be a dramatic cultural change with both Ofgem and DNOs if solutions are to be developed to facilitate the connection of greater amounts of generation to distribution networks. The current constraint of Ofgem working to purely economic factors clearly does not facilitate innovation and it may therefore be appropriate to give additional incentives, at least initially, to start the process off.

Geography and opportunity are key drivers for Distributed Generation. It is important that this is recognised by Ofgem and that the incentive for investment is sufficient to actively encourage DNOs to become involved in innovative projects. Starting from a low base and recognising that for every successful project there will be 10-20 failed initiatives, we believe it is important that funding is ex-ante with a

minimum factor of 1 for all schemes, with ex-post adjustments of much higher multiples.

The IFI framework must be comprehensive and explicit enough to allow DNOs to judge prospective projects against a standard template in order to determine their classification and the allowed level of funding. Any uncertainty over the level of recovery may limit the investment DNOs are willing to make, and therefore delay the development of Distributed Generation

Registered Power Zones (RPZs)

Registered Power Zones provide a way to facilitate investment in certain areas of distribution networks which any single Distributed Generation scheme does not. We believe that as with IFIs, the criteria under which schemes are to be judged should be clearly set out in advance in order that DNOs can assess the viability of such zones with certainty.

We believe that the number of RPZs will be naturally capped by resource requirements (both technical and financial) in the Distributed Generation sector and as such, we would not wish to see any artificial caps as proposed in the paper. Should RPZs be great in number then it will only prove the success of the scheme and lead to more Distributed Generation being connected.

As RPZs will require significant investment above that submitted by DNO's for the 'base case' scenario of the Business Plan Questionnaire, a higher rate of return will be required to fund them, aligned with the marginal cost of capital. We do not believe that the rate of return should be varied according to the level of innovation. Furthermore, it would not be practical to base financial rewards on the success or failure of a project. In a steady state it will be easier to evaluate the risk of success or failure and act accordingly. As this does not currently exist, and the level of innovative research is low, it would be better to reward all investment in innovative projects. Performance objectives could then be introduced at some point in the future.

We broadly agree with the suggestion in the paper that an enhanced £/MW driver could be used to deliver the premium rate of return. However, the MW capacity should be based on potential or expected MW rather than actual, in order to ensure recovery of the costs associated with the RPZ.

The paper suggests that a lifespan of 5-10 years would be appropriate for a RPZ, and hence the incentive. If, as the paper suggests, RPZs will be largely self funded then it is difficult to see why the incentive should not continue for the expected life of the assets used in the RPZ. Until RPZs and Distributed Generation become more commonplace in networks it is difficult to predict how they will interact with existing sections of our network, other RPZs and other DNO networks. It may be necessary to adapt technologies or RPZ characteristics in order to maintain an efficient and co-ordinated approach to network development. An extended incentive would also mitigate the risk of assets associated with an

RPZ being stranded in the event that the generator population scales down output or ceases operation.

Overall, the framework outlined in the paper seems a logical and workable solution although we would wish to see much more detail in terms of the classification of schemes and the levels of reward before lending our full support to the proposals.

Management of Intellectual Property

The paper suggests that a distributor who develops a product or solution which would be suitable for another area but not theirs, may not be encouraged to share it. The treatment of intellectual property will undoubtedly be dependant upon the parties involved in any initiative. Commercial companies such as equipment manufacturers will want to own the intellectual property rights to allow them to market the product or solution and give them an advantage over their competitors. Where DNOs collaborate under the guise of an industry body or individually, it would be appropriate for collaborators to share any intellectual property rights equally (or apportioned on level of investment made). Where development has been achieved with Innovation Funding Incentive support, we believe that there should be an obligation to licence the use of intellectual property rights to other users at an appropriate rate.

If you would like to discuss any of the points raised in our response, please contact us and we will be happy to discuss them with you,

Yours sincerely

Andy Phelps
Director of Regulation