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Dear Gareth

Date: 22 August 2003

### **Innovation and Registered Power Zones**

I write with SSE's response to the above discussion paper, issued by Ofgem in July. Some general points about the two mechanisms put forward by Ofgem are set out below and comments on the specific questions raised in the paper are set out in an appendix to this letter.

#### **Innovation Funding Incentive (IFI)**

We welcome Ofgem's recognition that innovation funding has a role to play in sustaining improvements in the cost and effectiveness of DNO operations. We are therefore broadly supportive of the IFI in concept. However, we are concerned that the proposed partial pass through of R&D expenditure (with the remainder funded by shareholders) will act as a significant barrier to DNOs taking advantage of the scheme. We therefore believe that all of the costs of R&D should be capable of being "logged up" against the new incentive scheme.

We are also concerned that the framework proposed by Ofgem could become rather prescriptive and bureaucratic and would therefore suggest that more flexibility is considered within the scheme - including fewer restrictions on the type of expenditure that would qualify for the incentive funding.

### **Registered Power Zones (RPZs)**

Similarly, we welcome the further development of proposals on RPZs. There is merit in formalising arrangements for more innovative schemes to connect distributed generation since, for example, some elements of the statutory framework may need to be relaxed which would need Ofgem's direct involvement. Areas we have in mind here are the planning standard P2/5 and the 90 day connection offer timescale.

It will also be important to clarify the matter of DNO risk in an RPZ area. In particular, we consider that it is important to consider what new risks, as distinct from extensions of existing risks and obligations will be faced by a DNO in bringing forward RPZ projects. In our view, the principal risk for a DNO within the DG incentive mechanisms being proposed, is that the anticipated MW of generation will not connect once the enabling investment has been made, thus risking the £/MW element of the return. This risk becomes greater where more innovative and untried methods of enabling DG connection are being considered and this is our understanding of the rationale for a premium rate of return, via the RPZ mechanism, for such projects.

Ofgem lists a number of risks for DNOs in undertaking RPZ projects at section 3.2 of the discussion paper. Most of these represent areas of business risk faced by DNOs which might be extended in the operation of an RPZ project. However, there are two areas where we strongly believe that the risks listed are new and inappropriate for RPZ projects.

Item 6 in Ofgem's list suggests a risk of stranded assets which, in our view, would undermine the DG and RPZ incentive if DNOs were to face any such risk that investment would not be recognised in the RAV. We are strongly opposed to any incentive scheme that does not provide reasonable certainty to DNOs that investment will be remunerated over its life.

Secondly, we do not believe that it is reasonable for RPZ status to entail the DNO picking up new risks, such as the risk on network availability, for example, that currently lies with the generator. Thus we would be firmly opposed to item g) of Ofgem's RPZ proposal that the DNO takes full responsibility to manage the risks of the scheme including liquidated damages to the connecting generator. This type of risk is noted at the second and third items in Ofgem's list which mention "the risk that the connection does not perform to specification" and liquidated damages. We are strongly of the view that these sort of risks are not appropriate for a DNO, even in the context of an RPZ.

Turning to other features of the proposed RPZ scheme, our remaining overall points are concerns about the complexity of the scheme and the limitations being suggested at the outset. We are concerned that the proposed RPZ may prove to be overly complex to the extent that DNOs feel unable to effectively participate. For the avoidance of doubt, we are very supportive of the concept, but we regard it as vital that the regulatory framework is simple and transparent. We are also concerned that the proposed limits on schemes may mean that in practice very few such schemes are brought forward. In particular, we are firmly opposed to the suggested 50MW limit for RPZ schemes. We see no reason for such a restriction, but we do believe that it will significantly inhibit the number of schemes that are brought forward under the RPZ framework.

We hope these comments are helpful and look forward to meeting you in a few weeks time to discuss the RPZ framework further.

Yours sincerely

Rob McDonald  
**Director of Regulation**

**Intellectual Property Question**

*1. Do you have any specific views on the management of intellectual property that may be created through the IFI and RPZ initiatives?*

We see no justification for additional regulatory obligations in respect of intellectual property rights.

**Innovation Funding Incentive (IFI) Questions**

*2. Do you support Ofgem's rationale for introducing the IFI? Do you consider the IFI to be aligned with consumers' interests?*

We would agree with Ofgem's assessment of the shortcomings of the current price control framework which provides little incentive for DNOs to innovate.

*3. What are your views about the use of the DTI's R&D Scoreboard as a yardstick in this context? It would be useful if DNOs could quantify their company's current R&D Intensity and offer their views on an appropriate level for the next DPCR period.*

SSE declared expenditure is £0.1m in each of the Southern Electric and Scottish Hydro-Electric authorised areas in 2001/02, with similar levels expected in 2002/03. However, the majority of innovation takes place as a result of people having ideas on operating practices and other matters as part of their jobs and the time spent is not easily logged up against "R&D". Thus total R&D spend is not easy to quantify and the formal figures understate the activity that is actually taking place under this heading.

We have no objections to the use of the DTI's R&D Scoreboard in setting the initial allowance for the price control. However, we are firmly opposed to the suggestion that only a proportion of actual R&D spend will be allowed to be "logged up" against the IFI allowance, with the remainder expected to be funded by shareholders. Given the relatively short-term nature of the price control, DNOs will not be certain of receiving a return on these investments. As a consequence, partial pass-through would, in our view, act as a significant disincentive to innovate and may undermine the rationale for the IFI. It is also important to note that reduced operating or capital expenditure does flow to customers after an initial period under the sharing arrangements inherent in the current capital and operating cost efficiency incentives and hence customers would still benefit under a full pass-through regime.

*4. Do you think the three category approach (A, B and C) and treatment of allowed funding is a reasonable balance in the interests of all parties? What should the value be of the proposed F1 and F2 factors?*

We recognise the general description of projects that Ofgem has categorised as A,B and C in table 1 of the discussion paper. However, in practice, it may well be difficult to fit potential projects into rigid categories. For the reasons set out above, we believe that allowable funding for projects specifically brought forward under the IFI scheme should

be 100%.

*5. What are your views on establishing good practice for the management of innovation and could such a framework be adopted commonly across the industry?*

We see no reason for the introduction of more formal regulation of sharing good practice. Where appropriate, DNOs will continue to share good practice using existing industry mechanisms.

*6. Should the IFI percentage cap be varied between companies according to performance or some other criteria?*

We believe all DNOs should receive the same £m allowance initially. It is difficult to see how Ofgem could objectively measure performance (particularly in advance) and hence vary the allowance across companies.

### **Registered Power Zone (RPZ) Questions**

*7. Do you share Ofgem's view that DG is likely to be connected more efficiently if innovation and new solutions/technologies are employed?*

We agree with Ofgem that, in some circumstances, innovation and new solutions/technologies will lead to more DG being connected more efficiently.

*8. Do you have a view regarding the annual RPZ MW capacity and numbers of projects that might be appropriate per DNO licensee per year, and whether the number should be allocated by the suggested gold, silver and bronze categories?*

We are of the view that it would not be appropriate for Ofgem to specify in advance any limits on RPZ capacity or numbers of projects of particular types. Indeed, we firmly believe that any such limit would result in efficient projects being postponed which would otherwise progress.

Each project should be proposed by the DNO and assessed by Ofgem. Especially in the early years of the initiative, we expect that there will be extensive discussions between Ofgem and the DNO to establish the parameters of the project. This process will naturally limit the number of projects that can proceed initially. In addition, Ofgem has also signalled an intention to review the operation of RPZs during the next price review period, and this might be the opportunity to bring in limitations on numbers of projects, if there is then felt to be good reason for this.

We are also concerned that the proposed assessment framework split between “gold”, “silver”, and “bronze” may be over-complicated.

*9. Should the premium return be common for all RPZs or should it be related to the innovative content of the project? If the latter is considered appropriate, is the gold, silver, and bronze approach helpful, or can you suggest a better alternative?*

We would be opposed to relating the scale of the premium return to the degree of innovation. We believe that this would be extremely subjective and moreover, the level

of risk to the DNO is not necessarily related to the degree of innovation.

*10. Is it practical to base financial rewards on a project meeting or failing to meet performance objectives?*

The matter of basing the financial rewards for innovative projects on a project meeting or failing to meet performance objectives should be treated with caution. The nature of innovative projects is that a significant proportion will not meet all performance objectives, but nonetheless some useful information may be gathered from the project having been undertaken. The innovation should therefore be encouraged, with a more limited “downside” if the performance objectives are not met. Furthermore, we believe that basing financial rewards on Ofgem’s assessment of success or otherwise would introduce significant additional regulatory risk. At the very least, in our view, no project should earn a rate of return less than the regulated WACC.

*11. Do you think a mechanism relying on an enhanced £/MW driver to provide a premium return is appropriate, and if not what alternative could be considered?*

We agree with Ofgem’s view that the RPZ incentive should adopt a mechanism similar to that of the proposed DG incentive in the main price control. We also agree that adjusting the £/MW driver to provide an enhanced premium return for qualifying RPZ schemes would be appropriate.

*12. What lifespan do you consider should be assigned to an RPZ and to the premium return?*

It is important that all investment should be recognised in the RAV over the lifetime of the assets concerned. Similarly, the length of time that the premium return is available through the £/MW term should be no less than that applying to the main DG incentive. For more innovative projects, a longer time would be appropriate.

*13. What premium do you consider to be appropriate to encourage innovation in DG connections and how could this be justified?*

There would certainly need to be a premium above the basic cost of capital to encourage a DNO to undertake innovative projects where the returns are less certain than those for core DNO investment. The exact level of the premium will depend on the interaction with the “pass-through” element of the proposed “hybrid” DG incentive scheme.

*14. Do you have a view on how, in principle, the boundaries of RPZs might be defined? Should they, for example, encompass a physical area, rather than simply an electrical node? Do you see potential, in design or operation, for outsourced specialist services?*

The natural boundary for an RPZ scheme will depend on the project being undertaken but should be readily identifiable. In most cases, we imagine that a physical area could be defined. There may be scope to consider the provision of specialist services from external parties, but it would be important to ensure that overall coordination and control of the project rests with the DNO.

*15. In your view, how should the RPZ initiative be funded?*

We firmly believe that the introduction of ongoing distribution charges for generators is unnecessary and undesirable. In particular, there is a real danger that targeting more distribution business costs at generators would undermine the economics of DG projects, which would clearly be counter-productive. We also believe that a distribution generation charge would be unstable and this would raise significant issues of regulatory risk, which would need to be reflected in DG project finance. As a consequence, we firmly believe that the costs of RPZ projects should be funded, in common with all other allowable distribution business costs, from the DNO's demand customer base. We do not believe that the cost per final customer would be material. In addition if, over time, these costs become significant in particular DNO areas, arrangements could be made to spread them more evenly over customers across Great Britain.

### **General Questions**

*16. Can you suggest alternative regulatory mechanisms that might better deliver the stated objectives of the IFI and RPZs?*

As noted above, we are concerned that the administrative arrangements around the proposed IFI may be complex and may themselves act as a barrier to innovation. A simpler alternative would be to include a £m allowance in the allowed revenue of each DNO, with a requirement for each DNO to report progress to Ofgem on particular schemes. Another alternative would be to allow DNOs to capitalise approved R&D spend in the RAV, which would be recovered in the normal way through the price control.

We are similarly concerned that the proposed RPZ may prove to be overly complex to the extent that DNOs feel unable to effectively participate. For the avoidance of doubt, we are very supportive of the concept, but we regard it as vital that the regulatory framework is simple and transparent. We are also concerned that the proposed limits on schemes may mean that in practice very few such schemes are brought forward. In particular, we are firmly opposed to the suggested 50MW limit for RPZ schemes. We see no reason for such a restriction, but we do believe that it will significantly inhibit the number of schemes that are brought forward under the RPZ framework.

*17. Would it be helpful to consider whether IFI and RPZ arrangements could be introduced on an interim basis, ahead of commencement of the next price control period in 2005?*

To facilitate achievement of the Government's targets of 10% of renewable generation by 2010, we believe that there would be merit in seeking an early introduction of the IFI and RPZ schemes before 2005, as an addition to the current price control framework.