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Our Ref: js/ra/190
Direct Dial: 020 7901 7366
Email: john.scott@ofgem.gov.uk

5 October 2006

Dear Colleague,

Open Letter Consultation on the Innovation Funding Incentive and Registered Power Zone Schemes for Distribution Network Operators

This letter initiates a consultation process on the Innovation Funding Incentive (IFI) and Registered Power Zone (RPZ) schemes that were introduced by us as part of the fourth electricity distribution price control review (DPCR4). Responses to this consultation will be welcome from all stakeholders that have an involvement or interest in these schemes. Responses should be sent to us by 30 November.

Introduction

Following a period of development and consultation lasting some two years, we introduced the IFI and RPZ schemes as part of DPCR4 in April 2005. The development process is illustrated in Attachment 1 and all of the documents referred to are available on our website¹. The objectives of these schemes can be summarised as follows:

- **IFI** – a mechanism to encourage Distribution Network Operators (DNO) to invest in appropriate Research & Development (R&D) activities that focus on the technical aspects of network design, operation and maintenance. The principal objective is to deliver benefits to consumers, taking a longer term view, by enhancing efficiency in network operating costs and capital expenditure.
- **RPZ** – a mechanism to encourage DNOs to develop and demonstrate, on their networks, innovative and more cost effective ways of connecting and operating generation. The aim is to deliver specific benefits to new distributed generators and broader benefits to consumers generally.

When we introduced the IFI and RPZ schemes we said that we would review their effectiveness after two years. Earlier this year we met with each of the DNOs to get direct feedback from them. As a result of these discussions we concluded that it would

¹ <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/distpricecontrol>

be helpful to bring the planned review forward by about six months so that any recommendations from the review could be put in place for the third year of the price control period. This open letter therefore initiates the review.

Progress to Date

There has been good progress with both schemes. The IFI actually came into operation on 1 October 2004 and the DNOs published their first IFI reports in the summer of 2005. These reports are available on our website² and provide a useful reference point from which to track future activity. In July this year, the second annual IFI reports were published and these are also available on our website (see note 2). These reports show good progress. Over the past year the average R&D Intensity³, perhaps the best single indicator of R&D activity, has increased from 0.08% to 0.2%. Prior to the introduction of the IFI the average R&D Intensity was less than 0.1% so that a significant increase has been achieved in two years. A summary of the activity levels for the DNOs is provided in Attachment 1.

The RPZ scheme has also shown progress. Three distributed generation connection schemes have been registered by us in three DNOs: Central Networks; Scottish & Southern Energy and EDF Energy. Unlike IFI, RPZ schemes require the participation of a third party (i.e. a consenting generator) and are therefore less under the DNO's direct instigation. Brief details of these schemes are provided here:

- **RPZ 1** – Central Networks – connection of wind generation using dynamic line rating technology
- **RPZ 2** – Scottish & Southern Energy – connection of renewable generation on Orkney using active network management
- **RPZ 3** – EDF Energy – connection of wind generation using novel voltage control technology

This Review

We will welcome views on all aspects of the IFI and RPZ schemes. Our discussions with the DNOs suggest that both schemes are working well in most respects and at present we are not minded to make any fundamental changes to them unless a very strong case can be made. The main issues that came out of our meetings with the DNOs are summarised here:

1. The level of the cap on IFI internal expenditure – this is currently set at 15% of total expenditure but a number of network companies have proposed that it should be raised. The average proportion of internal expenditure in 2005/06 was 15.53% with a range from 10.07% to 30.06%. As the level of the cap for total IFI expenditure is set for the current price control period, any increase in the proportion of internal expenditure will substitute for available funding for external expenditure rather than increase costs overall. If the cap on IFI internal expenditure is raised, what should the higher level be set at and what justification is there for this?
2. IFI eligibility criteria – these are described in the Good Practice Guide (Engineering Recommendation G85, available free of charge from the website of the Energy

² <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/ifirpz>

³ R&D Intensity is the R&D spend expressed as a percentage of regulated turnover

Networks Association⁴). There have been discussions with some of the DNOs regarding the eligibility of expenditure put forward under IFI and some DNOs hold the view that the criteria should be revised to include additional areas of innovation. In particular, the boundary between commercial and technical innovation may benefit from clarification.

3. IFI benefit assessment requirements – the Good Practice Guide indicates methods to assess the likely benefits of R&D projects. Are better methods available? Is additional reporting required to track delivery against these projected benefits?
4. RPZ constraints due to the lack of willing generators – a DNO cannot develop an RPZ without the support of a generator. Are there ways by which the number of good quality RPZs could be increased? How can DNOs be encouraged to market RPZ opportunities and/or to engage more proactively with the generator community?
5. The future of IFI and RPZ in DPCR5 – is it necessary to decide now whether one or both of the schemes should be retained after 2010 and if so why and for what horizon beyond 2010? An OXERA paper⁵ suggested an alternative would be to capitalise R&D expenditure (which could be structured to have the same financial value to the network operator) – what are the pros and cons of this approach? Another alternative would involve valuing the benefits that flow from the R&D rather than the costs – would this be preferable and how could it be achieved in practice? Does there need to be evolution after 2010 to strengthen the focus of IFI in its support for practical application – for example prototypes and network trials? If so, how might this be achieved and how would the transition work? With regard to distributed generation, are there other changes to the regulatory framework (e.g. to encourage active management – technical and commercial - by the DNO) which need to be considered?

We would particularly like respondents to this consultation to offer comments relating to these issues. However, we realise that non-DNO parties may have very different ideas about the IFI and RPZ and we would encourage you to include these as well.

Transmission Price Control Review (TPCR4)

The issue of innovation is also being discussed in the context of electricity and gas transmission price controls, TPCR4. A number of the issues being discussed are common with the DNO IFI scheme. We hope that this consultation will also inform our final decisions regarding the TPCR4 innovation proposals.

Workshop

We believe that an open workshop would be helpful in developing consensus views on the issues set out above. We are pursuing this idea at present and have set a provisional date of **Tuesday 21 November**. We would welcome views as to whether a workshop would be helpful within a week of the date of this letter. Please email Ronke Adenuga (see email address below) if you wish to express a view. We will publish details as soon as they are confirmed.

⁴ <http://www.energynetworks.org/spring/engineering/cms01/index.aspx>

⁵ Where has the innovation gone? R&D in UK utility regulation – Oxera 2005

Period for responses

All responses to this consultation should be submitted in writing or electronically to arrive at the following address by 30 November.

Ronke Adenuga
Ofgem
9 Millbank
London SW1P 3GE, and
Email: Ronke.Adenuga@Ofgem.gov.uk
Tel: 020 7901 7461
Fax: 020 7901 7075

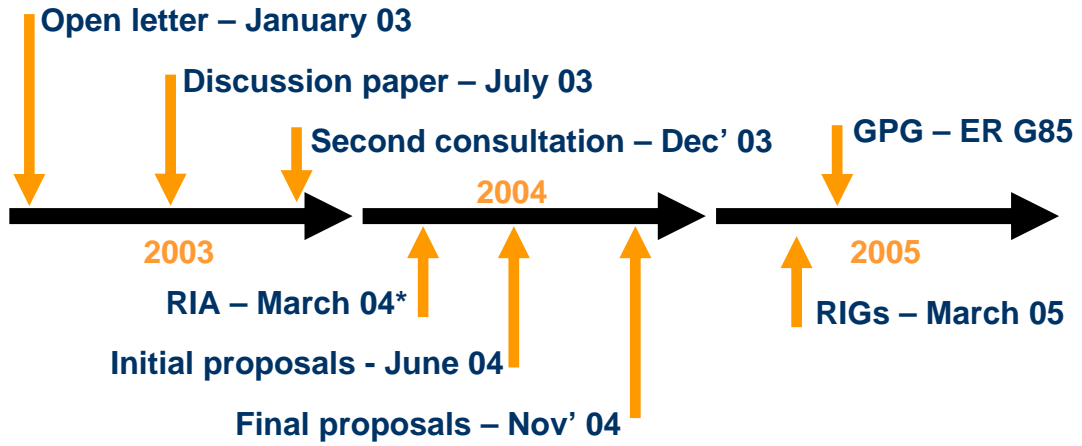
It is our intention to publish responses unless marked confidential. Ofgem intends to publish its conclusions from this consultation early in 2007. If you have any questions about the contents of this letter please do not hesitate to get in touch with me.

Yours sincerely,

A handwritten signature in black ink that reads "John Scott". The signature is written in a cursive style with a horizontal line underneath the name.

John Scott
Technical Director, OFGEM

Development & Consultation Process



*Mott McDonald/BPI Report published in April to support the RIA

DNO R&D Intensity

