CE Electric UK

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Dear John

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

I'm writing to you on behalf of Yorkshire Electricity Distribution plc (YEDL) and Northern Electric Distribution Limited (NEDL), the licensed electricity distributors of CE Electric UK Funding Co Ltd.

This letter is in response to your open letter consultation that was published on your web site on the 5th October 2006. We would like to thank you for giving us the opportunity to comment on the issues raised regarding IFI & RPZ in your open letter.

We have responded below to the issues that were raised in your open letter.

The level of the cap on IFI internal expenditure

In compilation of the 2005/06 IFI/RPZ annual report CE Electric incurred internal costs of 20.082%. At the time we made a request to Ofgem for the Z factor to be raised to 20%. We continue to support the view that the threshold value for the Z factor should be raised based on the following rationale:

- In keeping with the principles behind IFI the internal costs incurred have been for the project management and delivery of the projects into the business. We have not incurred costs establishing an internal R&D capability. To date our experience has shown the level of internal costs incurred to be around 20%.
- In keeping with the spirit of IFI, we have sought collaboration with other DNO's on many of our projects to deliver better value to our customers. This unfortunately reduces the ratio between external and internal costs due to the sharing of the external costs. The Z factor cap could discourage participation in collaborative or highly geared projects.
- The internal to external cost ratio can vary throughout a project, for example in the start-up and field trial phases the internal costs could be well above 15%, while in a phase which includes research by an external body the internal costs will be low. As these project phases can span several reporting periods an imbalance in the internal to external cost ratio between reporting periods can occur.
- For R&D work to deliver its benefit ultimately it must be implemented into the business. Part of the development cycle often includes trials performed on our network. To perform such a trial we have to provide internal resource to either perform the trial directly or to provide safe access to the network for a third party. As the IFI process becomes more established and projects start to move from a research phase into the development phase we believe that we will see an increase in internal costs incurred by operational staff performing trials. One possible solution to this could be to account for internal operational staff used for field trials as an external cost. In effect the operational

staff would be a sub contractor to the development project. This is based on the principle that either an internal DLO or an external service provider could fulfil this role but the decision on which to use is determined by the business's chosen resourcing strategy. A common approach to trial costs would prevent any perversities arising from the use of an internal cap.

IFI eligibility criteria

Generally we are happy with the guidelines laid down for IFI projects within G85 and with Ofgem's interpretation of the guidelines following the submission of the DNO's 2005/06 annual IFI/RPZ reports. While we agree that the majority of projects should focus on the primary current carrying assets we would welcome a relaxation of this definition to cover other aspects of technical development relating to operating a network such as safety, environmental improvements and substation security.

As stated in our earlier communication to you on the 13th September we would also welcome a review of the de-minimis project limit at £40k. At present EA Technology's Strategic Technology Programme (STP) is an example of where the de-minimis limit is being used. It is recognised that STP is an excellent vehicle to deliver small to medium collaborative projects. We are now reaching a situation where because of increased innovation activity the STP programmes are becoming full and worthwhile projects are dropping out. As a result of this, projects are been pursued by single DNO's and the opportunity for collaboration has been lost. This could be remedied if the de-minimis project limit was to be raised; a suggestion is to raise the limit to 10% of the total allowable annual IFI allowance. At the very least the de-minimis project limit should be inflation proof.

IFI benefit assessment requirements

The approach within CE Electric has been to justify all IFI projects based primarily on a financial NPV calculation but with consideration of other non-financial benefits. We believe that innovation focused expenditure can and should be assessed in a similar manner to capital investment. While we can be happy that we have a sound business case for each project this approach does tend to focus our portfolio on more practical projects where there is a clearly defined deliverable to the business at the end of the project. From a business point of view this is not necessarily a bad thing but it could discourage work of a more academic nature.

A suggestion from the IFI workshop held at Ofgem on 21st November was to introduce a scorecard for the assessment of benefits instead of a purely financial calculation. The scorecard would asses the projects against several criteria such as financial strength, avoided costs, safety improvements, environmental improvements and advancement in engineering knowledge. While we support the creation of such a system in the interest of creating a more balanced R&D portfolio we believe that the main emphasis should still be the financial benefit of the investment. The challenge then in introducing such a scheme would be evaluating none quantitive benefits in financial terms, guidelines for this would need to be included in the Good Practice Guide (GPG) G85. It is not clear how this would work for de-minimis projects where the benefit has to be described as a single entity; again STP is a good example of this where not all of the work performed will deliver a benefit to each company.

We have also recognised that we need to evaluate projects once completed to check that they have accomplished what they intended. This can be facilitating through the operation of post investment appraisal similar to that undertaken for capital investment.

RPZ constraints

Since DCPR 4 we have tried on several occasions to create an RPZ within CE Electric UK but so far have failed to build a sound business case for any of the schemes. However we do not perceive our lack of success to be down to the framework and incentives associated with RPZ's. In general from a DNO's perspective we are happy with the RPZ incentive scheme and do not believe it needs to change too much.

The difficulty is for a situation to occur that gives rise to a potentially viable RPZ. For this situation to occur, we need the coincidence of a willing generator, a network peculiarity that does not lend itself to traditional methods of connecting DG and an innovation that is deliverable within the time frame of the project. In the majority of cases traditional proven methods of connecting generation to the system will suffice on the CE Electric network where the level of penetration of DG is relatively low. In this case it is not sound business sense to look any further for alternative innovative solutions.

From a generators point of view it is not in their interest to favour an RPZ scheme over a traditional connection. Opting for an RPZ would in most cases add risk and delays to their projects. This situation may change as DG penetration increases and established methods are no longer suitable for the connection of additional generation.

In reviewing the future of the RPZ concept, we see two potential enhancements. First, better to balance risk and reward, there is merit in setting the RPZ premium with respect to the investment avoided. Otherwise, those ideas that avoid or defer multi-million pound reinforcement schemes for a few MW of generation leave distributors with the full risk of the potential reinforcement (if the novel solution fails) for only a small reward (perhaps tens of thousands of pounds per year for five years).

If we are to promote generation-rich distribution networks and have regard to sustainable development, it is also worth considering novel solutions that do something other than just connect generation. A mechanism that promotes innovation in integrating generation and demand should also reward schemes that use existing generation to reduce demand reinforcement costs. The current scheme does not, but the proposal above would.

This approach might also usefully be applied to novel approaches that reduce the need for demand reinforcement without any generation involvement, such as the use of demand-side management or energy storage

There is an emerging consensus (for example, as noted in your joint call for evidence on barriers to distributed energy) that 'private wire' networks offer many advantages as a vehicle to promote community energy schemes. We believe that it is in customers' interests to replicate the effect of private wires on public networks. This would require only a derogation from the requirement to enter all exit/entry points into the trading arrangements for certain (perhaps registered) parts of our system.

Future of IFI & RPZ in DPCR5

Firstly, we would like to give our support to the IFI & RPZ initiatives and hope that they are continued as it has stimulated worthwhile projects that will contribute to business performance. In general we see little wrong in how IFI is operating and believe that it is achieving what it was set up to do. We would be against a change to funding IFI based on valuing the benefits delivered by projects because we believe that this would be difficult to manage and would discourage participation in the more innovative projects which inevitably would carry higher risks to delivering a benefit.

One of the potential blocks on setting up long term R&D projects as we are heading towards the middle of DPCR4 period is the uncertainty over the future of the IFI. Even if the initiative is repeated in DCPR5 period we will be faced with the same problem again in five years time. A better solution would be to agree with Ofgem a rolling five year notice period for the initiative that is not necessarily linked with the price control reviews. If this commitment is made then we would have the confidence to commit to long term research projects.

An alternative would be to under-write long-term contracts, if these extended beyond a price control boundary.

In the short term if we are to continue building our R&D portfolio towards the end of the DPCR4 period we will require a commitment that the initiative will continue at least into DPCR5 otherwise we will be more inclined to pursue small short term projects.

Another issue which needs to be addressed is the decreasing pass-through level; we understand why the initiative was set up in this way to kick start the activity level within each DNO. Now that IFI has become established we feel that a better solution would be a fixed 80% pass-through level.

Within CE Electric the current cap on R&D intensity level of 0.5% has not been a problem as our intensity has been below this level and we do not foresee this being a problem within this price control period.

Once again we would like to thank you for giving us the opportunity to attend the workshop held at Ofgem 21st November and comment on the issues raised regarding IFI & RPZ in your open letter. If you would like any further clarification on any of the points raised in this letter, please do not hesitate to contact me or Garret Dakin (01977 746 5953).

Yours Sincerely

Mark Drye
Director of Asset Management