

Ronke Adenuga
Electricity Distribution
Ofgem
9 Millbank
London
SW1P 3GE
2006

30 November

Your Ref: Ofgem doc 181/06

Dear Ronke

Open Letter Consultation on the Innovation Funding Incentive (IFI) and Registered Power Zone (RPZ) Schemes for Distribution Network Operators (DNOs)

energywatch welcomes the opportunity to respond to the issues raised by the open letter. This response is non-confidential and we are happy for it to be published on the Ofgem website.

General comments

We are generally very supportive of the IFI and RPZ schemes as we believe that improved efficiencies in network design, planning and operation, and the incorporation of more distributed generation in innovative ways will assist in reducing network costs to consumers. An additional benefit to consumers is that more active network management may result, to allow DNOs and users to contribute effectively to energy efficiency and overall security of supply. We feel that consumers should benefit through sharing in the lower costs which we believe would result from greater innovation and that this will be reflected in a transparent manner when future distribution price controls are set.

We are pleased to note that the DNOs take an active and transparent approach to providing information on their individual progress with the schemes through the annual reporting process. We note that the measure of average R&D intensity has risen since the schemes were first considered. This appears to reflect a willingness on the part of DNOs to take a more active approach to managing their networks and would be of particular value in connecting new and different types of generation.

We believe that it is worthwhile reviewing these schemes earlier than anticipated if there is sufficient evidence that improvements are forthcoming and benefits can be realised earlier than otherwise intended. We will measure the success of the review on this basis. We also note the possible cross-over to the Transmission Price Control Review (TPCR) and believe that appropriate incentives to increase innovation for connections and use of the transmission networks may assist in providing the same efficiencies and economic operation whose benefits consumers can share over time. We consider below some of the specific issues raised in the open letter regarding the current impact of the schemes and their future.

Internal IFI expenditure

We understand the concerns of DNOs that a cap on internal expenditure may hinder the ability to undertake effective planning and execution of innovation projects over their lifecycle. The average proportion of internal expenditure noted in the open letter is around the level of the cap. However, it is not clear whether this is because a number of DNOs are limiting their expenditure to comply with the cap or whether the 2005/06 spending level is a reasonable reflection of the internal expenditure component of IFI projects to date.

Our main concern is that the spending level is efficient and that over-recovery of unnecessary costs does not eventually lie with consumers through the price control. We would agree that more rigorous auditing and reporting will assist in determining whether particular expenditure is appropriate or not, without seeking to inhibit DNOs from undertaking spending which is required to support identified projects. We also agree that greater development of internal resources by DNOs could have the tangential benefit of aiding the overall reliability of networks if a suitable skills base is created as a result.

An element of flexibility on internal expenditure may be appropriate to support different projects but we cannot say whether there should be a new cap level and at which rate this should be set. However, an open-ended commitment on internal spending is not necessary. It may even be helpful to look at R&D innovation in similar industries to determine a benchmark cap level for all DNOs.

IFI eligibility

We support the view that eligibility for IFI status may be wider than purely engineering innovation related to network design, planning and operation. There are wider areas of active management of networks which go beyond the current limited definition and which should be

considered for incentivisation. However, projects should be undertaken in a consistent manner, as the impact across networks may become uneven. Successful projects should be replicated based on a minimum benchmark approach for efficient delivery of network design planning and operation.

We agree that projects with environmental and commercial consequences should be included under the eligibility criteria. We are keen to see smarter metering and distributed generation develop, as there are potentially significant benefits to consumers through accurate and timely billing, energy efficiency and security of supply. Network innovation ought to be funded through the IFI to allow active management of networks to develop in response to these commercial innovations.

Assessing scheme benefits

We agree that there are a number of issues to be determined when a project is initially suggested, including both quantitative and qualitative benefits. The latter may not always be obvious but may have wider policy implications which will justify the project's delivery – reliability of network operation associated with lower losses which provides increased security of supply, and increased connection of distributed generation which improves sustainability of energy supplies. We support the need for an objective means of assessing risks and benefits which may remove the potential to develop some projects which may be appropriate for an individual DNO's network but have wider disadvantages.

We believe that there is scope for more innovation through collaboration between DNOs and specialist companies. There are common benefits of a more innovative approach which could be recognised in the funding arrangements – specific value placed on intellectual property which can be shared by all DNOs, to set a minimum benchmark for wider use in network design, planning and operation. However, these also need to be subject to rigorous and objective assessment. A consistent approach with PAS 55 asset management requirements may provide the degree of objectivity required so long as there is application of a common set of criteria.

RPZ activity

We agree that there is limited take-up in this area and that generators and DNOs should work together to increase innovation in network connection. There are potentially significant benefits if more generation connects at a time when security of supply is a key consideration for

consumers. However there must be a holistic and consistent approach to efficiently develop the network, accommodating individual projects flexibly and with firm financial commitments that prevent asset stranding.

We recognise that classification of 132kV networks in Scotland as transmission could be a limiting factor and Ofgem should consider whether RPZ can be provided with a kick start by using a more flexible approach in Scotland. It is also possible that the issue could be considered through the TPCR to address the impact of constraints.

Future of IFI and RPZ schemes

We see a real benefit to extending the schemes into future price control periods, potentially on a rolling basis. Some projects may have a lifecycle that starts part-way through one five-year price control period and conclude in the next period, although DNOs must also seek 'quick wins' to deliver benefits to consumers sooner. An early commitment to extend the schemes will also provide some funding certainty. So long as there are safeguards that prevent DNOs from gaming the schemes (and we hope rigorous reporting and auditing will assist this process), we are supportive of their extension to improve network delivery and security, and other wider policy objectives. We anticipate only limited changes to the schemes to maintain consistency, and even then, only those changes which provide necessary flexibility.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers.

We would appreciate being kept informed of the progress of the review and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs