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London, 30 November 2006

Dear Ronke

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

KEMA is supportive of initiatives to stimulate research and development activity in the power sector. We believe the IFI and RPZ provide an excellent opportunity to share and transfer technology, knowledge and best practices amongst distribution network operators and third parties. These schemes will increase overall R&D efficiency and will allow for more effective ways of solving common challenges, such as ageing infrastructures.

Review questions
KEMA's responses to the specific questions outlined in the open letter are as follows:

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?*

KEMA recognises that the cap on IFI internal expenditure may discourage DNOs to invest in small projects, as internal project management costs may breach the 15% cap. KEMA also recognises that the level of DNO internal expenditure often varies through life of a project.

A range of alternatives exist for controlling the levels of internal expenditure by DNOs:

- No cap
- Absolute cap
- % cap
- Sliding scale related to on project value
- Mixture of fixed and variable cap components
- Estimation of internal/external resources in proposal

KEMA's preference would be for the ratio of internal and external resources to be estimated in the initial business case developed by the each DNO such that each project is considered on its merits and a range of ratios could be accommodated. Subsequent review of outturn against forecast could be used to highlight any divergence in funding ratios accordingly.

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 Networks Association). 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.*

KEMA recognises the constraints on possible projects by restricting IFI investments to purely technical projects. KEMA supports broadening the eligibility criteria to also include the commercial implications of technical developments. Such broadening of the eligibility criteria could include elements relating to the full life cycle of assets, e.g. design, construction, commissioning, operation, maintenance and decommissioning. KEMA also believes it would be helpful to allow innovative new modelling related projects such as load flow, dynamic, stability, asset replacement and other probabilistic techniques.

To improve the clarity, KEMA believes it would be helpful to supplement the IFI eligibility criteria with additional statements providing explicit guidance regarding investments which would be deemed ineligible.

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?*

It is inevitable that some innovation related investments will have an uncertain outcome. No guarantee can be provided for delivery of a positive Net Present Value (NPV), although it is also possible that other benefits may be delivered. KEMA believes that other assessment criteria for benefit quantification may prove useful.

KEMA suggests that a mix of qualitative and quantitative non-financial measurements (some of which may be related to Corporate Social Responsibility) would complement the existing NPV calculation requirements, such that DNOs could develop a 'basket of benefits' for each potential project. These benefits may for example include, -

- safety
- reliability
- environmental
- responsiveness
- customer services

The new assessment criteria should be put in place whilst avoiding to increase the administrative burden.

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?*

KEMA recognises that the lack of certainty regarding the future of the RPZ initiative beyond 2010 may decrease the opportunity for some generators to participate, as extended project lead times effectively close the window of opportunity for investment. Extension of the RPZ scheme will therefore increase generators certainty.

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 papers 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? I f 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?

The IFI and RPZ initiative have been effective in delivering both innovation investment and increased levels of industry engagement. As these regulatory initiatives are now established and understood, KEMA would prefer to avoid any fundamental changes to the existing framework at this stage as this could stall the innovation investment process unnecessarily. Consequently, KEMA would strongly support extending the IFI and RPZ initiatives beyond 2010 and that any changes should refine the existing framework, instead of redefining it.

If you have any queries regarding this response, or if you require any further information, please do not hesitate to contact me.

Yours sincerely,

David Porter
Principal Consultant