Ronke Adenuga
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415
Email:

Our Reference:
Your Reference:

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Dear Ronke

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

I write with SSE's response to John Scott's open consultation letter on the above subject, dated 5 October and welcome the opportunity to comment on the IFI and RPZ schemes. We were represented at the recent workshop to discuss the schemes and felt that this was a useful forum to discuss and crystallise the issues from the point of view of the different interested parties. Overall, we believe that the IFI scheme is succeeding in promoting more research and development (R&D) within the DNOs and in increasing investment intensity. However, despite being involved in an RPZ scheme ourselves, we can see that RPZ incentive scheme has been less successful in bringing forward eligible projects. Both schemes suffer from a lack of certainty which we feel Ofgem must address in the short term. We note below our specific comments on the main issues identified in the open letter and have suggested some potential areas for development of these schemes in the final section.

IFI internal expenditure

The current 15% annual cap on internal expenditure seems low and our experience to date suggests that an overall figure of 20-30% is more realistic. We believe that the use of internal resource is essential to delivering the benefits from IFI projects and that the proportion required will vary with the type of project and over the course of a project's life. Having a specific limit could act as a constraint on the sort of research projects that a DNO would wish to pursue - for example, it could discourage investment in lower cost, external projects (because the fixed internal overhead would form a larger proportion of total costs). We therefore believe that, at the very least, Ofgem should allow a higher cap on internal costs and for this to be seen as an average over the five year period. We also support the points made at the workshop that, given the public reporting associated with the IFI; the need for DNOs to keep auditable records of internal expenditure on IFI; and existing drivers on DNOs to improve efficiency, Ofgem could remove the 15% limit entirely, without affecting existing processes or the incentive properties of the scheme. In our view, this would actually remove a constraint on the type and level of R&D activity that the DNOs could pursue.

In any event, it would be helpful if Ofgem could provide certainty on the treatment of the level of internal IFI costs reported by DNOs in the revenue returns for 2005/06 and subsequent years as soon as possible.

IFI Eligibility Criteria

We support the general theme at the workshop that a greater amount of beneficial activity could be carried out under the IFI mechanism if the definition of an eligible IFI project was broadened slightly within the Good Practice Guide (GPG) and made consistent with other aspects of the documentation, including definitions set out in the Regulatory Instructions and Guidance document (the RIGs).

Overall the documentation recognises that some projects are undertaken for non-financial reasons such as safety, environmental and supply quality reasons. For example, this is set out in Section 3.2.3 of the GPG, which recognises the fact that not all IFI projects individually will show positive Present Values due to the other benefits that may be considered when evaluating whether a project is worth pursuing. There is an overall requirement, however, that at least 50% of IFI projects would have a financial benefit, if successful, and that the portfolio of projects overall would have a positive Present Value on this basis. It would be useful for the definition of eligible IFI project at section 3.2 of the RIGs document to reflect this more closely. Currently, while this definition allows for projects to be undertaken for the non-financial reasons referred to above, the final sentence states that "Eligible IFI projects should be justified prior to commitment on the expectation that the present value of their costs will be exceeded by the present value of the benefits that could be delivered to customers.", which is at odds with section 3.2.3 of the GPG.

Similarly, the definition of an "eligible IFI project" in section 3.2.1 of the GPG is, in our view, unduly restrictive with its narrow sub-definition of "technical". Our suggested wording for this part of the GPG is as put forward by the DNOs at the workshop.

> *"An eligible IFI project must enhance the technical development of the distribution network. In this context "technical" means "benefiting the design, construction, commissioning, operation, maintenance, decommissioning and whole life management of the network infrastructure employed in the distribution of electrical energy."*

We believe that promoting this consistency between the GPG and the RIGs will increase certainty for DNOs on the characteristics of an acceptable portfolio of projects under the IFI scheme. The inclusion of "whole life" considerations in the definition of project eligibility would allow issues such as substation security and network risk to be addressed in IFI projects as well as wider issues of current political prominence in areas such as climate change, sustainability and environmental concerns.

Assessing benefits

We understand the importance that Ofgem attaches to this issue. We believe that the GPG provides sufficient guidance on assessing the likely benefits of R&D projects and that existing reporting arrangements under the scheme are adequate. However, we accept that identification and communication of successful IFI project benefits to a wider audience is an important part of demonstrating the worth of the incentive scheme. We suggest that the ENA R&D Working Group develops an annual and high profile guide aimed at communicating the benefits of IFI to an appropriate audience. This could contain a number of case studies covering every DNO and

we believe that a 'scorecard' identifying cultural, economic, technical, environmental and intellectual property benefits could also be developed for inclusion.

RPZ Constraints

As Ofgem is aware, SSE is developing an RPZ in Orkney. This project is progressing well and we have had a significant number of expressions of interest from generators. However, having had some experience of progressing an RPZ project, we do believe there are a number of issues that will affect the number of RPZ projects being brought forward and we discuss these below.

1. Cut-Off Point for Start of Five Year Premium Period

   The current structure of the RPZ incentive allows DNOs an additional incentive rate in £/MW terms for MW of generation actually connecting within an RPZ for a period of 5 years from when they connect. According to the rules of the scheme, this 5 year period must begin before 31 March 2010. However, significant factors outside the control of a DNO can affect the delivery of MW to the RPZ area once the DNO has registered the project and invested in developing the concept to be trialled, which itself can take some time and potentially involve collaboration with third parties. These factors include the lead times for generators obtaining finance and planning permission and for them to actually build their plant. Thus, for an RPZ that may be developed and brought forward to Ofgem for registration in 2007/08, for example, less than three years remain until the cut-off point, after which no premium is payable on any MW connecting in the RPZ area and there is no certainty on what incentive arrangements will be in place for the generality of distributed generation (DG) connections.

   On this logic, the further through the current price control period, the less attractive it appears to the DNO to invest effort in developing an RPZ. To resolve this issue, we suggest that the rules of the RPZ scheme are amended to allow a DNO to benefit from a full five years of the RPZ incentive package which was in place at the time that the RPZ was registered, for each MW that connects in the RPZ. There should be no time limit on when the MW connects, provided it is using the innovation concept that was registered as part of the original RPZ. This would remove the diminishing incentive to develop RPZs as the price control period progresses and provide certainty to the DNO on his financial reward should the MW appear in the RPZ. It would therefore entail "locking in" the parameters of the main DG incentive as well as the RPZ additional premium that prevail at the time of RPZ registration. However, as the MW concerned are already reported separately as specified in the DG RIGs, we do not expect that there should be too much amendment required to price control formulae. This would not need to be put into effect before the special conditions are amended as part of the next price control settlement, provided that Ofgem gives a clear undertaking of its intent in this respect. Clearly, the sooner such certainty is provided, the sooner this structural disincentive would be removed.

2. Early Release of Constrained Capacity

   One of the aspects of the Orkney RPZ project is that it allows DG connection on a non-firm basis, which would otherwise have to await the removal of a constraint (in this case, the capacity of the subsea cables between the Orkney Isles and the mainland of Scotland). By analogy, we consider that there may be potential RPZ solutions which could benefit and allow earlier connection for generators who are currently waiting in a queue for connection at distribution level due to the need for reinforcements of transmission capacity. As Ofgem are aware, there is a significant volume of generation in Scotland whose connection is contingent on transmission reinforcements such as the Beauly-Denny link. While these generators would

be able to rely on their connection offers for firm connection once the transmission constraint is relieved, they may be interested in achieving an earlier connection of a certain level of capacity on the basis of the current connection and use of system charging arrangements. Such new capacity would be made available under current charging arrangements such that it would be "relevant DG" and would qualify for both the DG incentive and the RPZ premium. However, it would be useful if Ofgem could clarify that innovative connection schemes in such circumstances would be eligible for RPZ status.

3. 132kV in Scotland
   We believe there may be innovative approaches to connection that might benefit generators connecting to the 132kV network in Scotland. Such innovation in England and Wales would be eligible for RPZ support but not in Scotland where 132kV is a transmission voltage. We therefore believe that more RPZs might be possible if Ofgem found a mechanism to support this.

4. Level of Incentive
   Finally, we believe that the current level of incentive for RPZs is proving insufficient to encourage proactive investigation of RPZ possibilities by the DNOs. Increasing the reward element of both the main DG incentive and the RPZ premium should result in more RPZs being brought forward. In our experience, in addition to the risks that are borne by the DNO in respect of whether MW will appear as a result of the RPZ innovation, there is significant work involved in analysing development factors which might lead to a viable RPZ project.

Future of IFI/RPZs

Consistent with the discussions at the workshop, SSE believes it is crucial to the future of the IFI and RPZ schemes that some certainty is provided to DNOs on how expenditure, commitments and revenue entitlement will be treated beyond the current five year price control period. We have made specific comments above on the effects of the cut-off point for the start of the five year premium period for the RPZ scheme but there are also considerations in relation to IFI. We discuss this below, followed by some comments on other possible developments of the IFI and RPZ concepts for the future.

- Five Year Rolling Framework for Eligible IFI Projects
  As the end of the price control period approaches, a DNO has no certainty, at present, that any IFI projects it might commence will be funded after 2010, which makes committing to any new, longer term projects problematic for the DNO from now on. To maintain the momentum of the R& D activity that the IFI scheme is intended to promote, we agree with the proposal put forward at the workshop that the IFI funding for eligible projects should be put onto a rolling 5-year basis. What we understand by this phrase is that, once an eligible IFI project is initiated, as reported in a DNO's annual report, it would be guaranteed to be funded until the end of the project or for five years, whichever is sooner, even if this rolls into the next price control period. This would give DNOs the certainty required to continue to develop a portfolio of projects that includes some longer term projects and avoid such activity "winding down" prior to 2010.

  It is recognised that the reducing level of pass-through percentage over the years of the current price control period has served its purpose in encouraging DNOs to engage in eligible R&D activity early in the current price control period. Going forward, it would seem appropriate to set a constant continuing pass-through rate for the years after 2009/10. Clearly,

the incentive properties of the scheme are greater for DNOs, the higher the pass-through rate and we would suggest that the ongoing flat rate should be set no lower than 80%, which is the average of the rate over the current price control period.

- Other Points
  SSE is in favour of extending the IFI and RPZ concept to other networks such as electricity transmission and gas distribution. We have been engaged in discussion with Ofgem during the price reviews affecting these networks and believe that an outstanding issue in relation to potential IFI scheme for electricity transmission is the definition of an appropriate level of funding for IFI expenditure for the smaller transmission licensees such as Scottish Hydro Electric Transmission Limited. In this case, a small percentage of allowable revenue would not support a meaningful level of innovation.

  We also believe that it would be worthwhile to consider how the RPZ concept might be developed to become more symmetrical in the sense of encouraging the DNOs to engage in projects which reduce demand, as well as promote distributed generation. Such projects, which might involve the development of energy solutions and energy storage to avoid the cost of infrastructure upgrades, would seem to merit a mechanism to encourage their development, given the developing political agenda on sustainability and the control of energy demand.

In conclusion, therefore, we believe there are a number of ways in which the current IFI and RPZ schemes could be improved, within the spirit of the intentions behind the development of the original framework. Of these, the most important are to provide the DNOs with certainty under both schemes on how they will be able to recover their costs for projects under consideration towards the end of the current five year period. However, in closing, we would like to emphasise that, notwithstanding the possible improvements we have noted, the IFI and RPZ schemes have led to significant additional innovation to date. Our suggestions above are intended too ensure that this momentum is maintained.

I hope these comments are helpful. Please let me know if you have any queries.

Yours sincerely

Rob McDonald
Director of Regulation