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Dear Anna

Consultation in relation to the second tier low carbon networks fund

Thank you for giving us the opportunity to comment on the approach to governance for the second tier of the low carbon networks (LCN) fund as invited in your letter of 24 February 2010. With a few key reservations, we generally support the approach that Ofgem has taken with the LCN fund. We appreciate that many of the comments and observations previously made by CE Electric UK and the other distribution network operator (DNO) representatives have been taken on board and incorporated into the existing governance documentation for the first tier projects. We support the overall objective of the fund's second tier, but we also recognise that there is much still to be defined and, in this response, we offer our suggestions as to how the overall objectives of the fund could be best met in order to achieve an appropriate outcome for customers and shareholders alike.

In this response on the second tier we have structured our response to focus on the four areas where Ofgem identified in its letter that it was particularly keen to obtain views. In summary:

- We support a broad range of project screening criteria in order that valuable projects are not disqualified prematurely.
- We support Ofgem's thinking that project eligibility criteria may be relaxed, relative to the first tier, since each second tier project is individually scrutinised by the independent panel as opposed to being self-registered as is the case for first tier projects.
- We advocate an associated change to the funding eligibility in order to enable a return on investment. Essentially, we continue to believe that companies should be permitted to retain the project benefits as opposed to being reliant on the discretionary reward to able to break even on the project costs.
- In relation to assessing the full proposals that enter the competition we believe that Ofgem should employ a ranking system largely based on the earlier screening criteria.
- We agree that intellectual property rights (IPRs) should be shared among DNOs such that the benefit is retained by their customers.
- Finally, for the discretionary rewards we consider that projects need an upfront set of clear objectives against which the appropriateness of a reward is judged.

Criteria for screening projects

We believe that it is important that the project selection criteria are as inclusive as possible. For the pre-selection process, the criteria (specific requirements) already set out for the first tier projects could also be applied for the second tier. These criteria are clear, yet broad enough that good projects are unlikely to be excluded at an early stage. We do not believe that these criteria should be weighted at this initial screening stage. Attempts to do so could mean that, through such weightings, a theoretical, "ideal" project would be identified and that this could encourage gaming of the fund at the expense of better ideas.

We note and support Ofgem's stated position that the second tier funding eligibility will be broader in scope than the first tier. We continue to favour a framework for second tier projects where it is possible for companies to earn a return on innovation investment. On the grounds of it being counter-productive to the overall objectives of the scheme and the promotion of innovative behaviour on the part of the DNOs, we are opposed to a continuation of the first tier eligibility for expenditure criteria where benefits accruing within the period of the investment are systematically removed from the net cost in order to ensure that a "tax" of typically 10% is then paid by the shareholder. We find it difficult to envisage how the return on our investment is likely to be earned at the next price control review due to the resetting of baseline investment levels as part of the review process.

We therefore believe that it is in the interests of all parties, particularly customers, that Ofgem provides an incentive for innovation that mimics the marketplace. Under such an approach, a DNO would be able to develop direct benefits as part of a second tier project and retain those benefits for the business, sharing these with the customer where appropriate. If the approach taken with the first tier is repeated in the second tier it is entirely possible that deployment trials of innovative technologies are discouraged in favour of using more standard engineering approaches. Whilst this may address a specific technical issue to the satisfaction of the customer it could lead to the LCN fund failing to achieve its primary objective of promoting innovation in networks in order to reduce carbon and the cost to future customers. In addition to these concerns, we are also perplexed as to why Ofgem would be comfortable with the obvious incentive that is set up to game the declaration of benefits.

Our preferred approach is that Ofgem abandons the attempt to identify benefits ahead of the project being authorised and encourage the DNO to find them and be open about that having done so. The discretionary award should be positioned as an appropriate means, at Ofgem's discretion (by definition) of a "good project" with net costs to the shareholder being rewarded ex post by the discretionary award covering the balance of the costs put at risk. We would not be opposed to Ofgem considering the application of a benefit sharing arrangement with customers, above a threshold at which the DNO has already more than covered its costs. For example, if the DNO has secured benefits that takes the 'recovery' to 150% of the project costs, then the next 50% could be shared with customers on a reducing balance, up to a maximum point beyond which the majority of benefit, say 90%, flows to customers.

In addition to the issues on overall return on investment, we continue to favour a relaxation of the first tier stance on the eligible scope for projects. In this respect the ability to fund equipment beyond the meter could prove to be the difference between a deliverable smart grid project and no project at all. We suggest that such projects should be considered for LCN funding where a partner with a commercial interest cannot be found or is unwilling to support potentially stranded assets.

Evaluation criteria for assessing competition entries

For the main proposal selection at the competitive stage, the same criteria should be used as for screening but a scoring methodology applied that numerically rates how well individual projects meet the overall criteria. This would allow for a range of projects to qualify, some scoring highly in one or two categories, others scoring more conservatively in across a larger range of categories. We recognise that these screening categories would form the foundation of good projects there is a need to introduce some additional categories in order to reflect the value for money the project represents, the quality and effectiveness of the learning and dissemination arrangements, and finally for the project risk and mitigation approach. We firmly believe that these final two categories are important in determining the rank of projects and should also form a key part of the discretionary rewards assessment process. We will return to this later.

The importance of risk identification and mitigation and the emergent nature of the type of projects envisaged as part of the second tier of the LCN fund also mean that a methodology for dealing with project change needs to be developed. The difficulty in predicting precisely what change might be required is difficult, so our preference would be for a consultative process where the need and case for such change can be made. A small sub-group of the selection panel, along with Ofgem representation may be the most appropriate forum for this. We believe that the lack of such a mechanism is a weakness of the first tier governance arrangements and Ofgem should take the opportunity to amend this approach for the second tier.

Treatment of IPRs

We believe that the policy approach suggested by Ofgem for the first tier is appropriate for the second tier. Therefore, we support the default approach whereby royalty-free licences for IPRs developed as a result of the project are provided to all other DNOs for use in Great Britain. Further, we support the proposal for situations where a DNO seeks to deviate from the standard approach. In such instance this should be discussed with Ofgem and any variation agreed prior to the commencement of the project but that this should very much be an exception to the general rule.

Criteria for discretionary reward

We support the use of a clear set of transparent, auditable criteria, laid out in the project proposal at the outset, against which qualification for discretionary rewards can be assessed. Without such a clear "before the fact" approach it is difficult to distinguish the discretionary from the arbitrary. Rewards could be tapered to deal with the issue of degrees of success as long as the criteria were clear beforehand. The discretionary rewards must also be able to cope with discontinued projects. Such projects, well run, are likely to contain much good learning, the generation and sharing of which should be viewed as positive outcomes and treated as such. For this reason we feel that the learning and dissemination arrangements should be a key part of both the project selection criteria and the reward assessment mechanism.

The mitigation of risk is also important in innovation projects, especially given that such projects, by their nature, are subject to emergent and therefore unpredicted outcomes. For the reward assessment mechanism a combination of the effectiveness of the project risk management and actual project outcomes also needs to be assessed, where the necessary modifications of the latter may be offset by the effectiveness of the former. In this way, what otherwise might be seen as a failed project, because of a failure to deliver an original planned outcome, can rightly be rewarded for the outputs that it does create. Additionally, under such circumstances the making of such discretionary rewards can be defended more easily in front of a broader cross section of stakeholders.

Regarding the size of rewards, the overall reward pool of £100m is relatively large compared to the project funding pool of £320m. We believe that this allows for a large number of discretionary rewards that at least returns the shareholders funding contribution in all deserved cases plus further fewer, but more substantial, rewards for projects that deliver "best in class" learning that has the potential to significantly transform networks.

In conclusion, we remain entirely committed to full and active participation in the innovation effort required to transition to low carbon networks. We aim to bring a progressive and innovative mindset to bear on all aspects of infrastructure asset management, but this must be done within a commercially credible context. We hope that Ofgem will take the opportunity in drawing up the second tier governance to address some of the shortcomings that are apparent in the first tier framework and enable innovation to flourish by appropriately setting the project criteria and funding eligibility for second tier projects.

I hope you find these comments useful. If you have any questions arising from this consultation response, please do not hesitate to make contact.

Yours sincerely

Chris Goodhand
Innovation Manager