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Dear Anna

Notice under Charge Restriction Condition (CRC) 13 of the Electricity Distribution Licence with respect to the LCN Fund Governance Document

Thank you for giving us the opportunity to comment on Ofgem's draft low carbon networks fund document. In general, we support the approach that Ofgem has taken with the low carbon networks fund and appreciate that many of the comments and observations previously made by CE Electric UK and the other DNO representatives have been taken on board and incorporated into the thinking represented in the document. In this response we focus on setting out the areas where Ofgem could improve the first tier of the fund, even at this late stage.

We continue to be opposed to an arrangement where many of the opportunities for us to innovate in order to pursue a return on our investment are deliberately and explicitly closed off. It is entirely reasonable to expect businesses to invest, at their risk, where opportunity exists for good performance to earn a return on investment. In this case however, 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 also believe Ofgem should be concerned about introducing such a clear incentive for companies to deny the existence of benefits within the project period. However we recognise that Ofgem appears committed to establishing the first tier on this basis. When defining the arrangements for the second tier fund we urge Ofgem to make it possible for DNOs to deliver larger projects that have a commercial payback.

Turning back to the tier one fund, there are several areas that still give us cause for concern in that they may provide a disincentive to behaviours that should drive outcomes which are entirely in the spirit of the purpose of the fund. These areas are those of the discretionary reward mechanism, the management of minor project changes, the impact of restrictions on the funding of smart metering trials and the dissemination of learning. We suggest that relatively minor modification of the first tier governance document would most effectively address our points. All of these specific points are also likely to be common areas of concern with the second tier governance arrangements where we consider that Ofgem should relax its first tier rules to ensure that worthy projects qualify for funding. We will be replying separately to this related consultation.

Our first point relates to the discretionary funding mechanism. It is difficult at this stage to understand what criteria are to be applied in reaching a decision on the making of such awards to reward learning. We are specifically concerned about the treatment of projects in which we took on ambitious targets but, because of that ambition and therefore increased risk, fell short of delivering the anticipated outcomes. Under such circumstances it is possible that a discretionary reward could be perceived as inappropriate, despite the project having realised excellent learning outcomes. This may place us in the circumstance where we expose ourselves to the greatest risk of both significant success and failure, but with the least chance of recovering the business' contribution. If returns are to be dependent on these rewards, then guidance on project qualification for rewards needs to be available in advance and needs to ensure that such incentives for high-risk projects are at least as good as for those with more certain outcomes.

Secondly, the governance document does not make provision for minor changes to the project scope and objectives. In any project where new technologies are being applied for the first time in novel arrangements there are usually emergent issues that cause the precise direction of the project to be altered. Where this required change is significant, the current requirement to close down and resubmit the project is warranted. However this is an excessive administrative burden for more minor changes to projects that are, by their very nature, exploratory. In addition, the lack of guidance on the discretionary reward causes us concern in cases where a project requires changes to scope and therefore has to be closed down. In such cases, the project may not qualify for a discretionary award of sufficient size to offset the business risk as the replacement project could be of a significantly smaller size, the bulk of the preliminary expenditure having been made on the original project. We suggest that a minor change of scope clause, where say 90% of the project remains unchanged, is included in the first tier document, to permit low materiality changes to project definition and avoid the need to close a project and resubmit.

Thirdly, the restriction within the fund that prevents the funding of innovation that might be located on the customer side of the cut-out also prevents the implementation of a key aspect of almost all smart-grid models. The inability to determine how customers will respond to price signals, in a real environment, is an important unknown behavioural element of an overall smart-grid system. We appreciate that there are smart metering specification issues being dealt with elsewhere and we appreciate that the second tier fund may not be as restrictive as the first tier. However, we believe that there should be provision within first tier projects to test out, on a relatively small scale, how end users will interact with a smarter lower-carbon distribution network. This interactivity is a key element of key low carbon concepts such as the home area network (HAN) and the key point of connection between such HANs and the distribution network is the smart meter or controller. It is essential that we are able to explore and understand this key interface.

Such trials, whilst vital to DNOs, would, under the current arrangements, require cooperative relations to be formed with suppliers who have already shown themselves to be reluctant to commit funding to potentially stranded assets, such as smart meters. We have already had conversations with suppliers where they have indicated this to be the case. To address this we suggest that a small, but statistically significant, number of end users, say no more than 200 per project, and the required smart equipment can be included within the funding boundary. Such arrangements could be subject to Ofgem scrutiny before the fact in the same way as intellectual property rights and related undertakings are to be treated.

Finally, we note that the dissemination of learning, as recorded in the governance document, is primarily achieved through the mechanisms of annual conference and close down reports. Given that the projects anticipated, in both tiers of the fund, are very much about the generation of experiential learning we can see a need for access to background information to adequately bring sharing of this learning about. We suggest that the governance document for the first tier is modified to include the explicit requirement that on request, any DNO should make freely available all the information another DNO would need to reasonable assess and implement the relevant solution for their network. This would include all project reports, drawings, work specifications, etc. The same requirement is also needed for second tier projects.

We would like to stress that despite our strong opposition to several aspects of the scheme we are entirely committed to full and active participation in the innovation effort required to transition to low carbon networks. We pride ourselves on bringing a progressive and innovative mindset to bear on all aspects of infrastructure asset management. Our objections are based on a simple commercial evaluation of the innovation funding framework and we believe that Ofgem should be prepared to let commercial incentives operate. By denying companies the benefits that accrue from innovation we do not believe that the framework currently being proposed will achieve that goal. Our preference is that Ofgem should enable innovation to flourish by removing many of the constraints on project and funding eligibility and, if required, provide protection through a threat of ex post clawback should the value to customers not be compatible with returns made by companies. As mentioned earlier, we understand that, at this late stage, these comments are more likely to influence the second tier framework since the implementation of the first tier is largely complete.

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