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Dear Anna

**Low Carbon Networks (LCN) Fund: Notice under Charge Restriction Condition (CRC13) of the Electricity Distribution Licence with respect to the LCN Fund Governance Document**

Further to your letter of 18 June 2010 regarding the publication of the third version of the LCN Governance Document, Electricity North West has considered the drafting and can confirm that we do not object to this Notice, but would like to make the following representations.

The requirement to set-up and manage a separate bank account for each Second Tier Project appears overly bureaucratic and burdensome and will increase the administrative costs for each Project, which will ultimately fall on our customers. We recognise the need to identify and manage the funds for each Project but this can be achieved within the existing financial controls of the organisation and therefore ask you reconsider this requirement. We suggest that financial management of Project funds should follow best practice and governance guidelines which can be demonstrated through Project audit.

Our interpretation of the proposed mechanism for calculating the net present value of the funding requested combined with the proposed payment mechanism means that Electricity North West would be left with a present-value loss on each of its successful Projects. We do not believe that this is the intention of the proposed drafting and ask Ofgem to clarify the details of the proposed mechanism.

We would also appreciate additional clarity on how the retrospective determination by Ofgem of Disallowed Expenditure will operate. Under one possible interpretation of the proposed definition, project managers would be deterred from reallocating funds between budgeted categories in situations where developments mean that this would be the most effective way to deliver the Project.

We have made specific comments regarding the drafting of the new sections and these are contained within Appendix 1.

If you wish to discuss any of the points raised please do not hesitate to contact me.

Yours sincerely,

**Paul Bircham**  
**Regulation Director**

## Appendix 1

These are Electricity North West's detailed comments on the third version of the LCN Fund Governance document.

### General

We agree that Ofgem should revisit the LCN Fund Governance document to ensure consistent use of the word 'Method' the across the First Tier and Second Tier sections. When undertaking this review we recommend that Ofgem develop as much as possible consistency of wording across the LCN Governance Document, the associated Pro-formas and workbooks and CRC13.

### Section Two

The LCN fund is an opportunity for the DNOs to understand the role that they can play within a low carbon economy. This may include trialling the commercial arrangements that may be required in a low carbon economy. It is possible that a DNO could seek a derogation from the connection and/ or charging methodologies in order to achieve this. This possibility is not recognised in the current drafting of the paragraphs for derogations.

The term 'Total Project Costs' used within paragraph 3.10 and the term 'Second Tier Funding Request' used within paragraph 3.13 are inconsistent with the terminology used in the Initial Screening and Full Submission Pro-formas.

To aid clarity on the methodology for the calculation of the Second Tier Funding Request described within paragraphs 3.9 to 3.13 the existing text should be supported by a mathematical calculation.

Our interpretation of the discounting methodology, described in paragraph 3.15, means that the Electricity North West is left with a present-value loss on the Project funding. There are some mechanism details that either require clarification or amendment. For example:

- It is important that DNOs are compensated for any difference between the timing of expenditure and the timing of revenues received by DNOs. This will be a complicated calculation as the different timing of expenditure in different projects will result in periods of negative and positive cash flow (for both DNOs and customers). The amount to be recovered is calculated by discounting to January 2011. The discounted amount is then recovered over the year from April 2011 to March 2012. To make this NPV neutral, (assuming the discount rate is appropriate), the recovery amounts would need to be uplifted using the discount rate to reflect the timing lag; and
- The discount rate is defined as Bank of England Base Rate + 1.5% (ie currently 2%). We assume that this rate is meant to represent the interest rate that DNOs can earn on the required separate bank accounts. We are unable to achieve this level of deposit rate in the current markets, for example 3 month and 6 month deposit rates are Base rate and Base rate + 0.5% respectively. If the requirement to retain separate bank accounts is to be retained, the discount rate should therefore be lower. Alternatively, if the requirement for separate bank accounts is removed, it would be more appropriate to discount at the cost of debt rate included within the WACC, recognising that DNOs will be able to offset borrowing requirements in the core price control against LCNF cash received. We believe that such an approach would demonstrate more effective use of customers' investment.

It states in paragraph 3.32 that Ofgem may appoint consultants to assist with the evaluation of all Second Tier Projects. To ensure transparency it would be helpful that the LCN Governance document clearly states how Ofgem will manage potential Conflicts of Interest between any consultants or Expert Panel members Ofgem may appoint and those being used by DNOs to assist in Second Tier Project preparation.

Electricity North West sees no argument for restricting the size of unallocated amount from the first year that can be reallocated to future years as described paragraph 3.16. The LCN Fund is new to all participants and although the number of Screening Pro-formas submitted shows the engagement of the DNOs there is a potential that no funding will be awarded in the first year.

With this in mind we suggest that there is no cap on the amount that can be reallocated across the following years.

Paragraph 3.93 states that Disallowed Expenditure includes “any funds that have not been spent in line with the approved Project budget” and does not clarify at what level of granularity this will be evaluated. Electricity North West is concerned that this requirement to spend in line with the approved Project budget could be interpreted at a level of detail which could penalise a DNO which has reallocated the project funds between participants, time periods or expenditure categories in order to deliver its project objectives and obtain best value for money. The European Framework 7 Financial Guide recognises that a research project budget breakdown is an estimate and states that “it is possible, without a supplementary agreement, to authorise certain transfers of costs between eligible cost items in the estimated budget within the overall amount of eligible costs ... provided they meet the definition of eligible costs ... and are incurred in the context of the activities permitted”. The Framework’s focus is on ensuring that costs incurred are necessary to achieve the project objectives and represent value for money. We suggest that a similar clause be introduced to the LCN Fund Governance document.

Paragraphs 3.34 & 3.61 refer to a report drafted by the consultants, appointed by the Ofgem, but the previous paragraphs only refer to a review undertaken by the consultants.

The word ‘lead’ is superfluous in paragraph 3.35, as the clarity on the use of ‘DNO’ throughout the document has been defined at the start of the section. The proposed ten working days notice period seems too short for a meeting of this importance, could the notice period be increased to say twenty working days?

We note that across paragraphs 3.38 and 3.39 the use of the words ‘Project’ and ‘Project(s)’ are used inconsistently.

Footnote 25 which is referred to in paragraph 3.46 highlights the traded carbon values published by DECC in July 2009. These figures were recently updated; will the LCN Governance document be updated to reflect the new values?

Paragraph 3.66 states “A DNO that is awarded Second Tier LCN funding must keep these funds in a separate bank account that....”. We believe that this requirement is overly bureaucratic and administratively costly, the additional cost will ultimately fall on customers. Setting up and managing a separate bank account for each Project is not as straightforward and practicable as it may seem. Managing a separate account requires duplication of many existing processes in our supply chain, administration and procurement procedures as these are all organised around our corporate financial systems and each Project bank account would have to be administered outside of these. To replicate all these systems for a new separate bank account would unnecessarily cause an increase in costs to manage LCNF projects. In a review of alternative arrangements for managing funding we have discovered that the European Framework funding does not mandate funding be kept in a separate bank account. The Framework 7 Financial Guide recommends that a separate bank account is set-up for the ease of identification of payments made or received and interest payable. But the Guide does not mandate the use of a separate account as it recognizes that these requirements can be met using an existing account under the existing audit and control mechanisms employed by an organization. We ask that you consider relaxing the wording in 3.66 in order that it is also just a recommendation.

Clarity on the arrangements for Discretionary Funding, described within paragraph 3.73, would be enhanced if the DNO defined within the Full Submission its proposed approach. To achieve this aim we suggest amending the wording in the second sentence of this paragraph to read “...unless an alternative arrangement **has been requested in the Full Submission and** is setout...”.

The meaning of paragraph 3.88 is unclear. Replacing the word ‘indentify’ with the word ‘redact’ could give clarity to the paragraph but we are not sure whether this was the intended meaning of

the author. Paragraphs 3.88 and 3.90 appear very similar in what they are trying to achieve and so expect that both are reviewed to clarify the meaning and remove any redundancy. The similar section under the First Tier is clearer and so this section should be similarly worded.

## **Section Five**

The meaning of the 'DNO Contribution' is unclear in the first bullet of paragraph 3.2. Does it mean the DNO Compulsory Contribution, the amount in excess of the DNO Compulsory Contribution, the sum of these amounts or something else? In the both bullets within this paragraph the terms Outstanding Second Tier Project Funding and Second Tier LCN Fund Funding are utilised yet there is no definitions for these terms in the LCN Governance document.

## **Section Seven**

The definition of 'Approved amount' is different from the definition contained in CRC13. Should this definition just refer to CRC13, like so many other definitions in the LCN Governance Document?