



Inveralmond House  
200 Dunkeld Road  
Perth PH1 3AQ

Anna Rossington  
Head of Distribution Policy  
The Office of Gas and Electricity Markets  
9 Millbank  
London SW1P 3GE

Tel: 01738 456571  
Fax: 01738 456415

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Dear Anna,

### **LCN Fund Governance Document v.3**

SSE welcomes the opportunity to comment on the third and final stage of Ofgem's LCN fund Governance Document. We have been encouraged by the work done to date in this area and believe that the scope and scale of the initiative has the potential to drive ambitious trials, which would not otherwise be able to go ahead. Notwithstanding this, there are a number of areas, both new and outstanding from previous versions, where we believe further work is still needed – two of which are particularly key.

#### **Funding lag**

Due to the lag in making the necessary adjustments to DUoS charges, there will be a mismatch between costs incurred and receipt of funding, at least in the year in which the project is registered. Section 4, paragraph 1.3 of the Governance Document suggests that this is more of an issue than we originally thought. Customer contributions to offset projects that are selected to go forward this year, will only start to be collected from 1 April 2011. Consistent with paragraph 1.52 of Final Proposals 145/09, the amounts raised via use of system charges to fund LCN projects must take into account the delay in actual funding being received.

In an effort to mitigate cashflow constraints, we believe Ofgem should consider bringing forward its current timetable so that it is in a position to issue the direction under 13.16 of Charge Restriction Condition 13 ahead of the October tariff change, rather than April. Given the sums of money, this would be a real help and would ensure that project costs can be naturally incurred rather than being shoe-horned into the back-end of the year in line with funding.

In addition, to ensure that any funding lag is limited to the year of registration, it is key that funding for multi-year projects is provided on an upfront basis. We believe this is consistent

with paragraph 1.20 of Final Proposals document 145/09 and Section 2, paragraph 1.9 of the Governance Document. We have, for example, put forward a significant project that is consistent with our understanding of the type of visionary project that the LCN fund is designed to facilitate. Within this overall vision, we have identified a number of discrete phases, each of which is a multi-year project. In terms of funding, by raising the required funding for the full phase in the year in which the phase is registered, this removes cashflow concerns in the years post registration and avoids complexities in trying to identify appropriate annual funding breakdown.

The same concern, albeit smaller in scale, exists for First Tier project funding. We have previously raised this concern and the fact that the Governance Document, which states that First Tier funding will be on an *ex post* basis (Section one, paragraph 3.4) is inconsistent with Final Proposals (Document 145/09, paragraph 1.30). Whilst we understand that due to practical constraints, allowances are having to be made to accommodate *ex post* funding in year one of DPCR5, we do not believe that this should continue to apply in subsequent years. Instead, we believe the Governance Document should reflect upfront funding, as is the intent of Final Proposals.

#### **Claw back of DPCR5 allowance**

We still have concerns over the proposal to ‘claw back’ DPCR5 allowed revenue where LCN funding is awarded to trial an alternative solution in place of planned and allowed for expenditure. Section 2, paragraph 3.14 of the Governance Document sets out that where a DNO’s DPCR5 settlement includes funding for a conventional solution that is (temporarily) avoided by a Second Tier LCN trial, it must use this funding to offset the DNO’s required contribution towards the trial. We believe this ignores the fact that if the trial is successful, funding will be needed to extend that trial for the remainder of the price control period. Similarly, if the trial is unsuccessful, the DNO will need to fall back on its original allowance to fund the previously intended conventional solution.

Moreover, if the project is unsuccessful and the identified direct benefits, which, in this example let’s say are greater than the DNO’s compulsory 10% contribution, are not realised, the DNO is not only exposed to the value of its compulsory contribution, but also the value of 50% of any direct benefits in excess of its compulsory contribution. Where the DNO’s minimum 10% contribution includes DPCR5 allowances that it had hoped that the LCN funded solution would avoid, the DNO, as we understand it, is exposed further by having to still find the funds to provide an alternative solution through to the end of the period. Importantly, were the DNO simply to have pursued its planned for conventional approach in the first place, it would have had the opportunity to outperform its allowance through efficiency savings.

Whilst we understand that the LCN fund is not designed or intended to give scope for outperformance, equally it should not leave the DNOs exposed to unreasonable costs. At the very least, where DPCR5 settlement has been used to offset LCN funds, LCN funding must extend to any costs that would otherwise have been covered by the DPCR5 allowance. For example, if it is possible to extend the life of the trial equipment through to the end of DPCR5, or, if that is not possible and there needs to be a more enduring solution or conventional solution put in place to take the network through to the end of the period, this funding must be made available. Not funding these costs, when the costs of the conventional solution that the trial (temporarily) replaces would have been fully funded via the DPCR5

settlement, is clearly not right. We strongly believe further work is needed in this area to ensure that the risks and exposures are more appropriate.

### **Additional feedback**

The remainder of this response focuses on the more general points that we have picked up in reading through the Governance Document. For ease, rather than listing these in order of priority, we have set these out in accordance with the order that they appear in the document.

In Section one, paragraph 2.17, we question the feasibility for DNOs to change their External Collaborator where there is a reluctance from the External Collaborator to accept the default intellectual property rights (IPR) requirement. In many cases, the IPR will go with the External Collaborator; changing collaborator may not therefore be a practical option.

On the allowable First Tier project expenditure, we believe Section one, paragraph 3.7 is confusing. We believe this would be clearer if it read “*a DNO is required to fund a minimum of 10 per cent of the Eligible First Tier Project Expenditure*” rather than “*a minimum of 10 per cent of the Project itself*”. The algebra makes this clear, but the words are at odds.


However, in the algebra set out in Section one, paragraph 3.8, we believe a more appropriate title for the term  $EPE_{it}$  is “First Tier Project Expenditure” rather than “Eligible First Tier Project Expenditure”. Eligible is misleading given that deductions are made to get to the expenditure that qualifies for funding under the First Tier mechanism.

The opening sentence in Section two, paragraph 1.1 of the document, which refers to “*a significant number of ‘flagship’ projects*”, is inconsistent with paragraph 1.10 on page 2 and paragraph 1.34 of Final Proposals document 145/09, which both refer to “*a small number of significant ‘flagship’ projects*”. The latter is more consistent with our understanding of the basis for Tier 2 funding.

Section two, paragraph 3.33 allows the DNOs just two working days to turn around any points of clarification sought by Ofgem, or its consultants, in relation to the Full Submission. Whilst we do not want to draw this process out unnecessarily and would endeavour to meet the two day target, we are concerned that this target does not allow for holidays or illness of key staff. We believe, as a minimum, five working days is more realistic.

Where projects incur a cost overrun, we do not believe this should automatically exclude them from any Successful Delivery Reward, as per Section two, paragraph 3.75. Given the nature and scale of the projects being put forward, where genuine and merited cost overruns occur we do not believe this should adversely impact the DNO. The converse of this is that it drives the DNOs to include contingency funding in their bids, which is not necessarily helpful. We believe the focus should be on funding all relevant, eligible expenditure and rewarding projects that deliver valuable learning.

Finally, we note in Section 5, paragraph 2.18 that fees associated with maintaining registered rights are expected to be paid by each Participant. We believe these should be recoverable under the funding mechanism, but would appreciate clarity on this issue.



As always, we hope this is useful input to what has been a fast-moving, but encouraging process. Should you wish to discuss any of the above in more detail, please do not hesitate to contact me.

Yours sincerely,

Malcolm J. Burns  
**Regulation Manager**