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6 September 2010

Dear Hannah

Response to Ofgem's July 2010 RPI-X@20 recommendations

Thank you for the opportunity to comment on Ofgem's proposed RIIO framework. Our detailed comments are included in the attached appendix. I can confirm that this response including the appendix is not confidential and may be published on Ofgem's website.

There are many aspects of the new RIIO framework which we support and will be pleased to see carried though into future price control reviews. We particularly support proposals to have the active engagement of stakeholders in building "richer" and longer term business plans, and the retention of specific incentive and funding arrangements for innovation. The coming decades will be a time of significant transition for GB's energy system as our economy decarbonises; a process in which networks will have a vital role to play. It is essential that the network companies are fully equipped to deal with the challenges this will pose, both in terms of making the right choices and of understanding the technologies that underpin the options available.

However, we cannot offer unqualified support for the RIIO proposals. Indeed, it is regrettable that there are a number of fundamental issues which we (and other stakeholders) have been raising for some time, but which nevertheless persist in Ofgem's recommendations, despite the strength of the arguments that have been made. These issues are discussed below.

The proposed financial framework for network companies

Ofgem rightly recognises that the transition to a low carbon economy will require significant investment in the electricity network and that distribution companies will need to attract finance to support this. However, the framework recommended under the RIIO framework could well deter investment rather than facilitate it.

With regard to electricity distribution, Ofgem's position appears to be that it can:

- significantly lengthen (possibly double) the period over which costs are recovered by extending the regulatory asset lives;
- rapidly transition to these new asset lives in one price control period; and even

- back-end-load the recovery of the investment in line with its forecast of asset utilisation.

Apparently, these can all be achieved without adding any regulatory risks, and hence will have no material impact on the cost of capital.

We do not find it plausible that lengthening the period over which revenues are recovered has no impact on risk, particularly in the context of a proposed framework in which equity investors are expected to inject funds to overcome cash shortages, in the expectation that future (unfettered) decisions by the Authority will allow them a counter-balancing cash surplus.

We accept that depreciation profiles should be based on the economic life of assets. However, we do not accept that this should only relate to future assets, as Ofgem's RIIO framework implies. Indeed, as has been highlighted by a number of respondents, including ourselves, current Regulatory Asset Values in electricity distribution are a small fraction of the associated Modern Equivalent Asset Values (i.e. the value of the assets in use) – meaning that current customers are, in fact, paying too little for the services they receive. Ofgem appears not to have considered this point, and as a result gives the impression that it is merely trying to find ways to artificially defer the recovery of investment costs.

Introduction of a limited mid-term review

While we can see some benefits in moving to longer term price controls, the timing of this proposal seems somewhat inconsistent with the degree of change that Ofgem has itself identified in its Project Discovery. However, our main concern with Ofgem's proposals is the high degree of uncertainty of the future outputs companies will be required to deliver and the fact that the proposed mid-period mini-reviews will focus on these, including any new outputs, without considering the financing requirements for them. As Ofgem's RORE approach demonstrates, there is a close association between the outputs required, the risks involved in delivering them, and the appropriate return of regulatory equity. We therefore cannot understand how Ofgem can avoid undertaking a review of the financial implications of revised outputs whilst continuing to comply with its financing duty.

We can also foresee issues if Ofgem increases or introduces new outputs without considering whether the price control framework provides the correct incentives to support the delivery of those outputs. In our opinion, a mid-period review that only focuses on the level of the outputs and the associated revenue, but ignores the financing implications and the interaction with the overall incentives properties of the price control framework, will raise the risk that companies face. Ultimately this will lead to increased costs to customers.

Role of third parties in price control reviews

Throughout the RPI-X@20 review we have stated our strong support for an enhanced role for stakeholders in business planning as the most effective means for third parties to input to the process. We are, however, unclear as to how Ofgem's proposals for third party challenge fit with this process. If Ofgem is aware of the third party views throughout the price control process we would expect it to take account of any valid views in the formulation of its proposals. If Ofgem believes that the views are invalid it is not obvious why Ofgem should ignore them right up until final proposals have been published, and only then decide to refer the proposals to the Competition Commission. We believe that the RIIO framework lacks coherence in this area and needs to be rethought.

Implementation of the RIIO framework

Finally, we remain concerned about Ofgem's ability to implement the RIIO proposals. The fast-tracking of companies through the price control process is a case in point. Ofgem's assumption is that it will front-load the price control process by making the decisions on key elements of the price control early on in the process, thus allowing it to determine the controls for some companies within a year. However, Ofgem (and other regulators) generally start a price review process with the ambition of resolving key policy issues early, but for a number of practical reasons, never seem to succeed. This is probably because important details emerge in the latter stages of the review once stakeholders have had time to fully understand the issues together with the regulator's initial views. Not only do we believe that fast-tracking will turn out to be impractical, it is far from clear that it would be advantageous to be a fast-tracked company.

I hope you will find our comments helpful. If you have any further questions, please do not hesitate to contact me.

Yours sincerely

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EDF Energy Networks

Appendix 1: Detailed comments on RPI-X@20 recommendations

Introducing sustainable network regulation

We are supportive of a number of the proposals in the RPI-X@20 recommendations, in particular enhanced stakeholder engagement and an increased focus on longer term outcomes. In our view, a number of the proposals are an evolution of the recently agreed DPCR5 framework, which we believe is sensible. However, there are four key areas where we have significant concerns with Ofgem's current thinking. These are:

- the approach to financeability, and in particular the remuneration of equity;
- the proposed fast-tracking approach;
- the practical consequences of lengthening the price control period and the role of the mid-period review; and
- the role of third parties in terms of their right to challenge price control outcomes and their potential role in delivering network investment.

Our concerns in these areas are set out in more detail in the relevant sections below.

It is also important that Ofgem does not underestimate the resources that it will require to undertake price controls, at least initially, as it moves to this new framework. In our view, the RIIO process will tend to result in more bespoke company price control reviews. It would be particularly disappointing if Ofgem did not sufficiently resource its review teams to deal with this additional complexity and had to revert to a "one size fits all" approach. In our view, this would significantly damage the credibility of the regulatory process and negate the potential value of many of the recommendations proposed in this consultation.

The price control process

At a high level, the structure of the price control review process appears sensible. Our major concern arises from Ofgem's aspiration to front-load the process, with many significant decisions being made in either stage 1 or stage 2 of the process i.e. within the first 12 months of the review. While introducing greater certainty at an early stage would be very welcome, the experience at DPCR5 was that important judgements on areas such as pensions, cost of capital etc were only concluded in the Final Proposals. The "fast-track" option described will surely require issues such as this to be decided within nine months of the start of the process. From experience of past price controls, we are not convinced that Ofgem will be able to meet this timescale.

We also note what Ofgem describes as the "whistleblower effect" i.e. that information might emerge from discussions with one company which prompts Ofgem to revisit or question information supplied by another. Ofgem needs to be explicit as to how it would deal with this situation where a company has fast-tracked to final proposals. For example, would it anticipate that it might re-open discussions with that company, potentially resulting in revisions to its final proposals?

Role of stakeholders in the price control process

In our contributions to earlier stages of the RPI-X@20 review, we have stated our strong support for an enhanced role for stakeholders in the business planning process. Like Ofgem, we recognise that this should form an ongoing part of our way of working rather than an ad-hoc initiative linked to a price control.

In the supporting paper, Ofgem sets out its thoughts regarding the operation of this engagement including the composition of the stakeholder community, the role of Government and the form of engagement with consumers. This is then complemented by a description of Ofgem's role and methods of engagement.

The suggested set of stakeholder groups that is identified at Figure 8, on page 19, appears a sensible starting point. We are pleased to see that Ofgem has considered and recognised the role of Government. There is uncertainty about both the direction and pace of development of the sustainable energy sector, and an ongoing discussion about security of supply. Government has an absolutely crucial role in bringing clarity to these issues, both of which have a major impact in respect of network development.

The description of Ofgem's role in enhanced engagement suggests a desire to focus on the "big picture" issues associated with the price control, whilst enabling the network companies to focus on the specific needs of stakeholders in their areas. We very much approve of this separation of responsibilities which we believe respects the very real differences that exist in stakeholder requirements from one area to another, whilst ensuring that there is high-level consistency across the review.

Key to the success of stakeholder engagement will be a belief amongst stakeholders that they have a genuine influence on the plans and actions of the network companies. Hence, the attitude of Ofgem to an issue such as "investment ahead of need", which is a core concern in London and other areas of economic development, will be crucial to the ongoing attention and involvement of stakeholders in these areas.

Our interpretation of the RPI-X@20 package as a whole is that investment ahead of need could be supported by Ofgem if it is a clear priority of stakeholders, and customers have indicated their willingness to pay.

Third party and Competition Commission references

We welcome Ofgem's careful consideration of the responses to this issue following the consultation on 'emerging thinking'.

We recognise that third parties have a legitimate interest in the outcomes of price control reviews, and it is appropriate that a properly constructed process takes account of their representations. We do not object to a third party challenging the conduct of a price control if it believes that there has been a failure in good process. However, we do not believe that it would be advantageous to the wider group of consumers and stakeholders if a small number of large, well resourced and well funded organisations have the opportunity to challenge a price control in defence of their own vested interest.

We acknowledge that Ofgem has sought to provide assurances that appropriate safeguards will be put in place to resist spurious challenges, however we remain concerned about the uncertainty that such an arrangement will bring.

One question that arises from consideration of the proposals as a whole is the status of the proposed mid-period review. Due to the focused nature of these reviews, it is not clear whether third parties will have any role in these discussions. We would be concerned that third parties may see such reviews as an opportunity to re-open a price control.

Equally we would like reassurance from Ofgem that these reviews would not be open to third-party challenge, as it is hard to see how a referral to GEMA or the Competition Commission would not result in a complete re-opening of the price control package.

Determining what network companies have to deliver

Ofgem's overview of primary outputs and secondary deliverables builds on the work that the DNOs have done during the DPCR5 process and provides clear signposts for future development. We agree that outputs should be at the heart of the regulatory framework. All parties should gain valuable learning experience of how the DPCR5 network outputs work in practice, noting that this new process has only just started and it is likely to take considerable time and effort on all sides to understand the full range of interactions between all activities.

We agree that primary outputs should be material, controllable, measurable, comparable, applicable and legally compliant. In addition to these attributes, the primary outputs also need to be coherent, in that the impact assessment should confirm that the primary outputs do not act against each other. For instance, the requirement to connect to a network within a target time may work against a Load Index-type measure which focuses on the utilisation of the network.

Looking ahead, the provision of well justified business plans, as described in a number of references in the consultation, sets both a challenge for the network companies and also an expectation of the response which should be forthcoming from the regulator. In particular, the option for a company to submit a level of primary output that is more or less than Ofgem's base level would appear to suggest that such justifiable variations would be acceptable, together with the associated investment submission.

We welcome the acknowledgement that investment planning for future needs must be an integral part of the well justified business plans. While the consultation seems to focus more in terms of facilitating a sustainable energy sector, it should not be forgotten that the 25 year horizon is equally important when we consider that there is the potential to decommission perhaps a substantial proportion of network assets over this period, and that replacement decisions will determine the development of the network into the second half of the century. Environmental primary outputs such as visual impact (not just in protected areas) and emissions could be strongly affected by fundamental policy decisions such as the use of oil or SF6 and the decision to construct indoor or outdoor installations.

We agree with the principle that Ofgem would not apply retrospective judgement on the justification for investment (and would not penalise for unsuccessful innovations). The provision of well justified business plans sets a level of expectation that Ofgem will test the company's investment proposals and reach an agreed view, thus accepting that those proposals (however modified) would be accepted as reasonable and efficient. It should also mean that Ofgem would accept that the well justified business plans anticipate reasonable alternative, innovative and collaborative delivery solutions. Given the range of possible funding mechanisms which could be applied in order to cover uncertainty and other factors, Ofgem's discussion of options to attach a financial penalty to a secondary deliverable could be seen as reluctance to engage fully in the process.

It will be necessary to ensure that the overall suite of primary outputs and secondary deliverables represents the minimum data set consistent with forming a view of a company's performance. We noted the comments made by Frontier Economics concerning the potential risks which lie ahead when balancing output-based and input-based regulation. In particular, the creation of a credible and well understood boundary between delegated autonomy to the operator and intervention by the regulator is essential. Frontier Economics makes the point very well that there are highly significant "dangers" in applying financial penalties based on imperfect measures, which could lead to increased regulatory involvement in the form of an "ever-lengthening rulebook", or increased regulatory involvement in real-time management of the system.

Well justified business plans and proportionate assessment

We understand and welcome Ofgem's thinking on this, in particular the scope for companies to present their plans in their own formats and to present their cases for variations to primary outputs.

In the light of the DPCR5 review, we deduce that the "well justified business plan" would most likely have a minimum scope based on further development of the current RIGs documents, supported by a detailed narrative and backed by information at least as thorough as that presented during the Supplementary Question phase, with baseline and scenario versions. There would also be a 25 year high level plan. In addition, companies may present information that might assist in the assessment of other companies, presumably if Ofgem decides that this would be relevant.

This assumes that there is a background comprehensive annual reporting process to review progress against the current plans. In all probability, these well justified plans could be over a thousand pages of detailed and dynamic information for a large company. It appears that key factors in determining Ofgem's classification of category A, B or C include complexity and the presence of high value projects, so the "lighter touch" level of scrutiny would, in part, seem to favour a company that has no extraordinary or outlying features or issues (such as operating in London).

We note that the treatment of category B and C companies may require different assessment tools, and we note that these would not discriminate between these companies and category A companies. We also note that information revealed during this extended and deeper scrutiny of category B and C companies could require the prior settlement of category A companies to be revisited.

Given the scale of the plans which must be submitted, combined with the need to take account at an early stage of specific proposals and information which could require other companies to present supplementary information and the potential for Ofgem to initiate third party delivery options, we would anticipate that Ofgem would need to commit substantial resources to the process in the long term. This should not be underestimated.

Encouraging longer term thinking with the price controls

Inflation indexation

We believe that RPI should be used to index all elements of the price control. With regard to the RAV (and associated returns) and price control revenue, the key characteristic of an inflation index is that it should be the best approximation to the inflation rate faced by investors who in themselves are consumers. It is widely accepted that RPI is the best measure of consumer inflation. There is an argument that cost lines could be indexed by CPI as long as any RPE factor was calculated on the same basis. However, having a mix of indices would seem to overcomplicate the price control process for no discernible value.

Length of the price control period

In our response to the RPI-X@20 emerging thinking consultation and the strawman paper on longer term price controls, our position was that we favoured retention of the five year review period in conjunction with both longer term business plans and outcomes. This remains our position.

In principle, we can see benefits in having longer term price controls as this provides greater surety for investors. However, our current stance is based on the fact that the environment facing distribution network operators (DNOs) is likely to be subject to rapid change, both in technology and customer behaviour, over the next 10 years. This level of uncertainty makes longer term forecasting problematic, particularly in anticipating what services the network will be required to deliver and how they should be delivered. We firmly believe that DNOs should have a long term vision of where they need to get to, based on the best information currently available, and that their plans should show that they will deliver this cost-effectively over the long term.

However, there is a significant possibility that the outputs DNOs are required to deliver may change in the medium term, as stakeholder requirements clarify generally and specifically around the challenges of the low carbon economy. This is why we believe a five year review period is appropriate at this time, as it will provide the necessary flexibility to meet these challenges. Ofgem also recognises that outputs may need to change given that the key element of the strawman is a mid-period outputs review. However, it is unclear to us how Ofgem will assess the appropriateness of the outputs, and the associated revenues, without undertaking a full stakeholder review. Such an approach would not be small scale. We also do not see how Ofgem could change outputs and revenues without considering how this would impact on other key aspects of the regulatory framework, specifically the cost of capital. In our opinion, investors could see any new proposals as a change in the level of risk, particularly given that outputs and revenues could change, increasing uncertainty in the long term. This is inappropriate, and if implemented, we believe it would raise the underlying level of the cost of capital within the regulated energy industries.

It is also important to recognise that the proposals, if implemented, would negate the concept of the price control as a package. The removal of this important concept will result in significant additional management time being spent on examining and negotiating each element of the price control review, as there may not be the ability to trade off performance levels in different areas. As a consequence, future reviews are likely to be even more resource intensive for both Ofgem and the companies, rather than less so, as Ofgem envisages under its proposals.

Proportionate assessment

In responding to the earlier emerging thinking consultation, we were concerned about the lack of clarity over how judgements might be made as to which companies merited lighter touch scrutiny. Hence we are pleased to see more explicit guidance being provided in these documents.

We note that Ofgem is proposing relatively swift decisions (three to six months) as to how it categorises companies. As described previously, the business plans could be very substantial, if they resemble the RIGs submissions. Also experience at DPCR5 would suggest that any form of cost benchmarking, whether it be historic or forecast, can be a complex and time-consuming exercise. Hence there must be some doubt as to the feasibility of completing this work within the time constraints demanded by the proposed process. This raises concerns that subjectivity will be applied when faced with 14 business plans. This must be resisted by Ofgem.

As we have stated previously, it is our belief that Ofgem should move to more tailored price controls, which enable a discussion between Ofgem and the network company as to particular stakeholder requirements in its area, and agreement of a business plan designed to support the delivery of these.

We welcome the development of the "assessment toolkit" which includes a range of sensible methods and techniques. The selective use of these techniques, guided by the particulars of past performance and the proposed business plan, has the potential to foster a more worthwhile discussion between Ofgem and a network company which focuses on specifics rather than a broad brush review of the entire content.

Ofgem has adopted a sensible position in respect of the role of benchmarking. We are pleased that the findings of the Frontier Economics paper have been endorsed, and agree that a focus on total cost benchmarking is the right way forward. However, Ofgem should not underestimate the effort required in establishing the correct value of the capital cost component to be used in any total cost benchmarking approach. We would encourage Ofgem to begin its work in this area as soon as possible.

Ofgem has achieved the right balance in recognising the value of benchmarking to support its decision-making processes, but without taking an overly mechanistic view that revenue allowances can be directly derived from the outputs of benchmarking.

We endorse Ofgem's view that the IQI mechanism still has a role to play in the assessment toolkit, and agree that it would be wise to review its value as the new framework becomes embedded.

We recognise that a line needs to be drawn on revisions to the business plan so that the IQI can be applied. However, it is equally important that there is complete clarity as to Ofgem's expectations in terms of outputs ahead of this, so that business plans can be aligned with these. Only at that point can Ofgem make a fair comparison of forecasts.

Use of third parties in delivery

In our response to Ofgem's emerging thinking consultation, we, like much of the industry, raised our concerns over the emphasis that Ofgem was placing on the use of third parties.

Our response could be summarised in two statements:

- Working with third parties, in the delivery of both opex and capex activities, is very much the norm for most, if not all, network companies.
- We were very sceptical as to the benefits of carving out projects to hand to third parties on a design-build-operate-own basis, and could foresee many practical obstacles in making such an approach work.

In reviewing Ofgem's further thinking on this subject, it is encouraging to see that Ofgem has accepted some of the points made in respect of handing over projects to third parties for delivery. Having this option available if a network company consistently fails on delivery of its outputs may prove a worthwhile incentive, however it is our view that projects which lend themselves to this approach will be relatively few and far between. The tasks of tendering, licensing of new operators and negotiating interface agreements with the affected network company are likely to challenge the timely and efficient delivery of such projects.

In respect of market testing, we are somewhat surprised by the tone of this section as it rather suggests that network companies are reluctant to embrace the use of third parties. In reality most companies have little option but to do so, due to the breadth and volume of work that they face, but also because of the flexibility these arrangements bring. This is only likely to increase over the coming years as new technologies, requiring new methods, become increasingly commonplace.

From an EDF Energy Networks perspective, the scale of our capital programme in particular, but also our day-to-day operations, has required us to make use of third parties, and over the past five years or so, we have significantly evolved the contracting relationship we have with such companies so as to deliver the most efficient delivery arrangements.

We are not convinced that it is the role of Ofgem to pass judgement on decisions to in-source or outsource a particular activity, and would question whether it has the commercial and technical expertise required to make such decisions. It is our firm belief that Ofgem should resist the temptation to attempt to micro-manage. It should rely on appropriate incentive mechanisms to encourage network companies to adopt delivery solutions that are both efficient and sustainable.

Uncertainty mechanisms

We support Ofgem's overarching principle that it is the responsibility of network companies to manage the uncertainty that they face.

Ofgem sets out a number of mechanisms which will allow changes to the revenue allowance to be made during the price control period. Many of these mechanisms are familiar and we would support their continued use where appropriate. However, we have outlined our concerns with the introduction of a mid-period review.

We are also concerned that as the price control period lengthens, the range of uncertainty will increase. A feature of these mechanisms is that they are not activated until a materiality threshold is triggered. As the number of mechanisms grows, the aggregate amount of additional cost a company bears, before a mechanism is triggered, is likely to increase. It would therefore seem sensible to have a mechanism which triggers when the aggregate cost across all uncertainty schemes exceeds a defined threshold.

Ensuring efficient delivery is financeable

We remain particularly concerned by a number of Ofgem's proposals relating to financeability. We agree that equity has a role to play in funding future RAV growth. However, we would expect Ofgem to recognise that the cost of capital is a cost that is set in a market, as our other costs are. As such, the only correct cost of capital is that which efficient firms must pay to attract capital. Therefore, if the Ofgem model assumes both investment grade debt and low cost equity then the framework must provide the conditions for this to happen.

Our key concerns relate to the remuneration of equity. In our opinion, regulated companies must offer both stable and continuous dividends to attract low cost capital. As the value of the company is the value of its future dividends then, at the extreme, if a company paid no dividends, the value of the company would be zero and its cost of capital infinite. Analysts (and hence investors) have viewed the regular dividends derived from GB energy infrastructure companies as a key indicator of the stability of the associated regulatory framework. Consequently, the key risk that delaying dividends will have is an increase in the perception of regulatory risk. We envisage that the concern of investors would be that if Ofgem is proposing to suspend dividends to fund a growing investment programme, there is a risk in the future that this becomes part of the regulatory "toolbox" to address other financing problems, resulting in them never getting their investment back. In such a situation we would expect any equity investors to require a significant premium for this risk, thus raising the cost of capital. We do not believe this would be in customers' interests.

The choice of depreciation policy is equally important for investors, and delaying these payments is also likely to raise the cost of capital. In principle, depreciation allocates costs through time allowing for all changes in value. We would therefore expect all energy infrastructure companies to have front-loaded depreciation, as the following factors will tend to reduce the value of the asset over time:

- Technical progress
- Rising operations and maintenance costs
- Stranding risk

We believe that the CEPA assumption that the depreciation profile for electricity distribution could be back-loaded is incorrect. The electricity network is currently designed to cater for a certain peak demand. Typically, a growth in peak demand will not result in increased utilisation but in more assets. We accept that the move to a low carbon economy will increase off peak usage but we do not see why this additional usage should attract a depreciation charge.

In theory, we would expect the chosen depreciation life to match the useful economic life of the assets. However, the issue for electricity distribution is that the existing RAV is a mixture of both operational and capital expenditure, which has varied over time, and hence determining a useful economic life would be difficult. It could be developed for new assets, however this would require the unpicking of the current DPCR5 approach where a fixed proportion of all costs are added to the RAV.

In conclusion, our concern is that even allowing for a transition profile over the next price control period, the scale of change proposed to both depreciation profiles and dividend payments will ultimately result in a higher cost of capital. We do not believe this is in customers' long term interests.

We also understand Ofgem's desire to mechanise the calculation of the cost of debt. The use of a long term average to automatically set the cost of debt may set the cost of debt either too low or too high. Consequently, we do not think this proposal fits with either Ofgem's consumer or financing duties which relate to the specific price control period in question. In our view, Ofgem must carry out an assessment of the required cost of debt at each review period rather than delegate it to a mechanism. Dependent on Ofgem's final decision on the length of the price control period, there may be benefit in indexing the cost of debt within the price control period, if a suitable index can be found.

Innovation stimulus package

EDF Energy Networks is very supportive of many of the features of the proposed innovation stimulus package. It is our view that there are a number of aspects of the wider RPI-X@20 proposals which will raise the status of research and development (R&D) within our industry. This will go some way to restoring its role after many years in which the regulatory framework discouraged expenditure in this area.

Notwithstanding our concerns over the practical issues associated with lengthening the price control period, we welcome Ofgem's recognition that efficient companies must focus on the long term. The suggestion that innovation will be de-coupled from a fixed price control cycle, thus recognising that some of the more far-reaching developments may span more than one price control period, is a good one. We would support schemes which reward DNOs on the basis of achievement of milestones.

IFI and Tier 1 allocations have been made available to all DNOs on the basis of either revenues or numbers of customers served. No pre-discussion has taken place during the price control review as to exactly what the DNO would plan to spend such allowances on, or the level of engagement intended. It is our hope that the introduction of the well justified business plan will allow companies such as ours, which have a clear commitment to R&D, to place innovation at the centre of our business, clearly linked to the objective of delivering sustainable energy networks in our areas.

We do believe that it is important that some R&D is recognised and supported by Ofgem outside of the competition for funds. Firstly, the time and cost involved in competitive bidding – for industry, third parties and Ofgem – should not be underestimated. Secondly, and more importantly, the certainty of the IFI allowance over the last five years has allowed a research base to become established. Furthermore, the certainty of the IFI allowance has given confidence to others to co-fund both at the front-end (consisting of basic research) and the back-end activity of commercialisation.

All of these would benefit from certainty of funding over the multiple price control periods outside of a strictly competitive process. We feel that paragraph 14.40 lacks a check that once the stimulus package is removed, the remaining R&D agreed in the individual DNOs' business plans represents a sufficient "critical mass" for the industry.

Extension of the competitive environment within the LCNF to TSOs

Overall we have a concern over whether a competitive environment is the correct one in which to drive out potential changes to the regulatory structure required for a sustainable energy sector.

We believe that forums such as the ENSG and LENS projects provide a better basis to consider such issues. There is the possibility that DNOs, TSOs and energy service providers will seek to use R&D to promote the aspirations of their own companies rather than find the most efficient mode of operation for the energy sector as a whole. Ofgem will need to consider carefully how it proposes to introduce TSOs into an innovation stimulus package based around the existing LCNF.

Extension of the competitive environment within the LCNF to third parties

This option is already included in DPCR5 as a fall-back option for companies not seen to be engaging with the LCNF, and has been the rationale for requiring the ENA to establish a database of suppliers and proposals interested in the LCNF in order to assist them in gaining access to DNOs.

Other aspects of the proposals suggest that Ofgem believes that there are companies it can trust on delivery and those it needs to scrutinise in more detail. However, this approach implies that all companies might "block" innovation and therefore, measures are required to ensure access for third parties.

It is not clear what evidence exists to support this stance. There are a number of third parties who are taking an active and shaping role in areas such as Smart Grid Maturity Models. We are not aware that they are facing any issues with DNOs seeking to marginalise them, nor that they would welcome gaining access to the network by means of this regulatory instrument.

Both the ENA database and LCNF itself are in their infancy. Furthermore, there is plenty of evidence of DNOs seeking out collaborators.

There are two further points which Ofgem should consider:

- Firstly, we imagine that a bid for innovation funding will only be compelling if it sets out issues currently being experienced on the network and concrete actions to address these. Without detailed network experience, it seems unrealistic that third parties will be able to diagnose issues and identify potential solutions.

- Secondly, Ofgem will continue to require an expert panel and consultants to support this panel. Newly licensed R&D providers would logically be ruled out of the expert panel or consultancy roles, yet by definition must have intimate industry knowledge. Expansion of the competition to early stage R&D will also rule out additional players, such as universities, from the panel. We have serious concerns over whether the UK has the depth of expertise to support all of the roles required in providing the governance and oversight.

If Ofgem is concerned about particular sectors or technologies which it feels that DNOs are not engaging with, we would prefer to discuss these concerns and would welcome the challenge to describe our strategy with respect to this area as part of our business plan.

EDF Energy Networks
6 September 2010