



To transmission companies,
distribution companies, generators,
suppliers, customer groups and
other interested parties

*Promoting choice and value for
all gas and electricity customers*

Your ref:
Our ref:129/10
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Date: 12 October 2010

Dear Colleague,

Open letter consultation on the development of gas and electricity innovation stimuli

Britain's gas and electricity industries are facing a significant challenge to meet the demands of moving to a low carbon economy and meeting our renewable targets whilst maintaining safe, secure and reliable energy supplies. Networks will need to be smarter, integrating increasing local renewable and intermittent sources of gas and electricity production and encouraging customers to manage their demand.

Although the shape of the low carbon future is not clear, network companies will need to innovate in the way they design, build, operate and charge for their networks to deliver smarter networks and encourage customers to change their behaviour. We anticipate that billions of pounds will need to be spent on pipes and wires over the next 10 years, and companies need to anticipate and explore how they can ensure these investments are cost effective and fit for purpose.

On 4 October 2010 the Authority published its final decision¹ to implement Sustainable Network Regulation using the RIIO model (Revenue = Incentives + Innovation + Outputs). The RIIO model builds on the success of the previous RPI-X regime, but provides stronger incentives on companies to innovate where needed to deliver improved customer service and smarter grids at value for money. The gas and transmission distribution price control reviews² (GDPCR2 and TPCR5) due to start on 1 April 2013 will be the first controls to reflect this new regulatory framework.

Many elements of the RIIO model should help promote technological, operational, commercial and charging innovation. The outputs-led, longer-term price control framework should provide stronger incentives on network companies to seek out more and different types of innovation than under the RPI-X framework. We anticipate that network companies will search for new ways to deliver the primary outputs, and that the longer term price controls and business plans extending beyond the price control period will enable the companies to demonstrate the commercial benefits of adopting the new innovation.

¹ <http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/Decision%20doc.pdf>

² The TPCR5 open letter consultation can be found at:

<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/ConRes/Documents1/Open%20letter%20TPCR5%20way%20forward.pdf>. The GDPCR2 open letter consultation can be found at:
<http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR2/ConRes/Documents1/GDPCR2%20%20July%202010%200pen%20Letter%20FINAL.pdf>

However, we recognise that for innovation related to the wider sustainable energy sector where the commercial benefit of the innovation may not be clear, network companies may not have a strong motivation to pursue innovation in a timely way. Therefore the RIIO model also includes a time-limited innovation stimulus package to supplement the incentives in the price control framework.

The stimulus package will take the form of regular open competitions for partial funding of research, development, trials and demonstration projects to help understand what new technologies, commercial and operating arrangements might be required to serve the interests of future customers. The package design seeks to adopt many of the principles established in the Low Carbon Networks (LCN) Fund for electricity distribution³, and extend them to other parts of the energy networks with broader access by other parties.

This letter consults on the development of the innovation stimulus package, and sets out the following:

- the proposed approach for developing the innovation stimuli,
- the key interactions with the price control reviews, and
- the high-level timetable for putting in place licensing and governance arrangements to support the establishment of the stimuli by April 2013.

Gas and electricity innovation stimuli

The RIIO handbook published alongside the RPI-X@20 Decision document⁴ sets out the high level elements of the innovation stimulus package:

- separate stimuli for gas and electricity networks,
- both network and appropriately licensed non-network parties can apply for funding,
- the package will be funded by transfers of consumer monies across licensees,
- the package is aimed to encourage innovation at any point of the innovation cycle related to the delivery of networks required for a sustainable energy sector
- all parties receiving funding under the scheme will be required to share the information and knowledge gained from the projects, and
- we expect it to be time-limited - until such time as incentives embedded within the framework are found to be encouraging the required innovation.

Electricity distribution network operators are already incentivised to trial innovation projects through the LCN Fund. This was established as part of DPCR5 to encourage innovation that would facilitate the delivery of a low carbon energy sector. We have committed to retaining the LCN Fund until 2015 when the DPCR5 period ends. From that point onwards, we expect that funding arrangements to encourage innovation in the electricity distribution sector to be incorporated into the broader innovation stimulus mechanisms set out in this letter. We will consult on how best to transition from the LCN Fund to the innovation stimulus package. We are committed to ensuring that any transition does not disrupt the operation of the LCN Fund or put at risk commitments that we have made on projects funded through the LCN Fund.

Key development work-streams

We have developed a provisional timetable for the development and implementation of the governance and licensing frameworks that will support the innovation stimuli. The key milestones are set out in Annex A. We have structured the work into two key work-

³ More information on the LCN Fund can be found at

<http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Pages/lcnf.aspx>

⁴ <http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/RIIO%20handbook.pdf>

streams, the development of governance and funding arrangements, and the licensing and third party access. These work-streams are discussed below.

Governance and funding arrangements

In order to implement the new stimuli for 1 April 2013 and to inform specific elements of the price control reviews, we will design the governance and funding arrangements in three phases. We will:

1. design the key elements that will inform the network operators' preparation of their business plans – for inclusion in the Initial Strategy consultation document published in December 2010 and Strategy decision document in March 2011,
2. design the remaining features of the stimuli, such as project eligibility, how the funds will be raised and transferred between parties, partial funding, third party participation, and the dissemination of learning – for consultation in spring 2011, and
3. design the detailed governance document(s) – for consultation in mid 2012.

In this letter we set out questions to inform the first phase.

In line with the RIIO model, we expect that companies may justify certain elements of innovation within their business plans. For example, companies may request a level of funding to carry out research, development and trialling without having to go the competitive process, or they may identify new products/operating/commercial approaches that are more expensive in the price control period, but the company can justify will pay off in the longer term. In advance of the deadline for company business plan submissions, it is therefore important that we provide clarity on requests for innovation funding directly as part of the price control settlement, and the funding available through the innovation stimuli.

We therefore intend to set out the following in the December and March documents:

- the amount of funding available under each innovation stimuli,
- the requirements for partial funding of project costs that will apply under the stimuli, and
- guidance on the justification of innovation within the business plans.

All other aspects of the stimulus, including the design of the competitive process, will be addressed in the second phase.

We would at this stage welcome views on:

- ***what innovation might be required to facilitate a low carbon economy and securing supplies as efficiently as possible in each of gas distribution, gas transmission and electricity transmission sectors,***
- ***how the annual level of funding to facilitate the innovation in each sector should compare to the £64m available annually under the LCN Fund,***
- ***details of potential projects you consider could meet the objectives of the gas or electricity stimuli and the potential cost of these projects, and***
- ***what speculative investment companies should include in their business plans to be funded through the price control, versus what they should compete for through the stimulus – and the potential value and required justification for this speculative investment.***

Licensing and third party access

Within the RIIO model we have extended the innovation stimulus beyond network companies by allowing suitably qualified non-network parties to develop new and innovative ideas for network development. Third parties with expertise in areas such as

telecoms, smarter grids and sustainability will be able to bring new ideas and ways of working to the industry.

A new class of licence gas and electricity is required to enable third parties to receive funds under the stimuli as money raised from consumers can only be transferred among licence-holders. Licences will be limited only to matters relating to the innovation projects funded through the stimuli – to enable the licensee to receive funding and to provide Ofgem with powers to ensure the scheme is properly administered. We need to apply to the Secretary of State to issue an order designating this new class of licence.

We need to have enabling licensing arrangements in place before 1 April 2013. We will therefore be developing, in consultation with stakeholders, the licence conditions that will apply to activities under the scheme over the course of 2011 in order to meet this deadline.

The licence conditions we develop will reflect our proposals on facilitating third party access as set out in our RIIO handbook published alongside the RPI-X@20 Decision document. They will also reflect our further considerations of placing an obligation on network parties to provide access to non-network parties on reasonable terms.

In addition to holding a new licence, prospective third parties will have to demonstrate that they are well placed to undertake innovation related to network services. We will therefore be considering over the coming months how this could be carried out in a streamlined way, for instance, by including a pre-qualification round where, among other matters, third parties would need to demonstrate their ability to comply with relevant safety standards when trialling on network assets in order to be eligible to hold an innovation licence. We expect to set out our thinking on these issues in our consultation planned for spring 2011.

Stakeholder engagement

We propose to establish a working group to test initial thinking on the issues which need to be resolved to implement the RIIO innovation stimulus proposals. We envisage that the working group will meet approximately monthly from November 2010 to October 2012, with the meetings chaired by Ofgem. All material generated by the groups will be published on a designated section of the Ofgem website.

We would like the working group to be open to prospective third parties who may be interested in seeking to compete for funding under the stimuli, and to wider stakeholders who can make a significant contribution to considering the issues. ***We invite any interested parties to indicate by 22 October if they would wish to be involved in the innovation stimuli working group and to set out what contribution they could make to the group.***

We will host a plenary session for all stakeholders at the beginning of November 2010 to discuss the issues set out in this consultation; our proposed way forward in implementing innovation stimuli and our current thinking. ***We invite any interested parties to indicate by 22 October if they would be interested in attending this event.***

Views invited

We would welcome views on any of the issues set out in this letter but particularly in relation to:

- the key questions we have asked about the requirement for innovation in the gas distribution, transmission and electricity transmission sectors,
- our proposed approach to stakeholder engagement, and
- the key milestones we have highlighted (Annex A).

We would welcome responses to this letter by **23 November 2010**. Unless clearly marked as confidential, responses will be published on our website. Please email responses and expressions of interest to anna.rossington@ofgem.gov.uk.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is written over a light grey rectangular background.

Rachel Fletcher
Partner, Smarter Grids and Governance

Annex A: Key milestones

Date	Key Milestone
October 2010	Publication: Open letter consultation on the way forward for introducing gas and electricity innovation stimuli
End October 2010	Stakeholder plenary session
November 2010 – October 2012	Meetings of the innovation stimuli working group
December 2010	Publication: Initial strategy consultation documents for TPCR5 and GDPCR2, including initial proposals on key elements of the innovation stimuli funding arrangements and business plan guidance.
March 2011	Publication: Strategy decision documents for TPCR5 and GDPCR2, including decisions on key elements of the innovation stimuli and business plan guidance.
Spring 2011	Publication: Consultation document on remaining features of the stimuli
Summer 2011	Publication: Decision document on remaining features of the stimuli
Summer 2011	Publication: Consultation on new innovation licence
Late summer 2011	Publication: Statutory consultation on new innovation licence and engagement with the Secretary of State
Autumn 2012	Publication: Innovation stimuli governance document(s)
April 2013	Commencement of transmission and gas distribution price control periods, and “go live” of stimuli