CE Electric UK

Anna Rossington
Head of Distribution Policy
Ofgem
9 Millbank
London
SW1P 3GE

98 Aketon Road
Castleford
West Yorkshire
WF10 5DS
tel: 01977 605938
email: jim.cardwell@ce-electricuk.com

23 November 2010

Dear Anna,

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

In response to your letter of 12 October 2010, here are some comments on the RIIO innovation stimuli proposals.

Before turning to the specific questions raised in your open letter consultation document I would like to make some general points. These points initially relate to the overarching shape and design of the innovation incentives package. These issues have been raised as part of our discourse on the low carbon networks fund and I think they are also relevant to the innovation stimulus price controls. Also, Ofgem should reconsider its position on the need for parties other than network companies to apply for funding since there is a more straightforward route to achieving the policy objective.

If companies perform well and deliver high quality learning, the rewards should include recovery of at-risk costs as well as additional rewards for the best projects. These rewards should be contingent on the projects being effectively delivered as opposed to certain learning outcomes being achieved. It is quite possible that a well-delivered project may fail to prove a hypothesis or fail to provide the envisaged solution for quite legitimate reasons. This is the approach taken under the low carbon networks fund. Alternatively, if Ofgem wishes to only reward "successful" learning then the rewards would need to be increased to take account of the risk associated with a competently-delivered project delivering this "negative" learning. We anticipate that these rewards would need to be significantly higher and it is for this reason that we think this alternative and more extreme risk/reward balance is inappropriate.

Further, there is another dimension that we would counsel is important to consider in order to deliver an effective innovation framework. Ofgem's natural tendency is to examine and determine the appropriateness of the detail of network companies' plans in order to drive down costs and ensure outputs are appropriate. This behaviour of the regulator has played an important part in incentivising companies to reduce their costs since privatisation. However the management of innovation requires a different mindset from the regulator in order to encourage the best from companies for the benefit of customers. The nature of technical and commercial innovation is that the regulator must primarily focus on the problem and solution definition. The costs, while important, cannot be micro-managed in the same way that this is done for other cost categories in companies' plans. Our experience in the development and implementation of the low carbon networks fund is that Ofgem could do more to recognise clearly this distinction and differentiate its behaviour accordingly.

Ofgem needs to consider whether it is necessary to encourage and enable third parties other than the network companies to lead on projects. The first year of the low carbon networks fund has demonstrated that network companies have been open to working with consortiums to bring forward high quality project proposals. Ofgem could retain the principle that others may lead on projects but only invest what could be a considerable effort to make this possible unless experience shows that it is ultimately necessary. Currently, the experience in electricity distribution means that this need is unproven since there is no apparent blockage to good projects being presented for funding with only distribution network operators able to lead.

I now turn to providing specific answers to the questions raised in your letter.

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

Ofgem has made clear its rationale for providing two separate innovation stimuli price controls separately covering gas and electricity network sectors. Innovation projects to reduce carbon may involve solutions that encompass both sectors. For example, increased use of electrical heating as a substitute for gas-fired heating will impact both gas and electricity networks. It is likely that a specific solution will primarily be aimed at benefiting one of the two sectors' customers. Therefore the "split scheme" is not an issue so long as it is foreseen and made permissible that there can be secondary benefits for the customers of the other alternative network type.

How the annual level of funding to facilitate the innovation in each sector should compare to the £64m available annually under the LCN Fund

When assessing the "demand-side" needs for innovation in the gas and electricity sectors there are a number of factors to consider when considering the size of the funds:

- the likely future role of that network type in delivering the low-carbon goals;
- the projections of the future investment required in that sector (for example, as estimated by Ofgem in Project Discovery); and
- the current size of the regulatory asset value.

It is hard for us to comment on the range and scope of projects formally submitted for the inaugural round of the low carbon networks fund since the details are not in the public domain. Ofgem is in a much better position to form an opinion. However, from what we can see, the number, quality and total value of projects brought forward do not suggest that the annual fund value of £64m in the electricity distribution sector is unreasonable. It therefore provides a reasonable "supply-side" capability-for-innovation comparator when considering the appropriate value for the other network sectors.

Details of potential projects you consider could meet the objectives of the gas or electricity stimuli and the potential cost of these projects

The larger smart grid thinking and widespread network trials involve innovation across boundaries and with the different participants in the energy supply chain. The most valuable projects are likely to be those that focus on delivering joined-up solutions across the value chain.

We continue to support the funding of technical and commercial innovation since both aspects are crucial in order for the industry to deliver low-carbon solutions.

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

We believe that projects of smaller value (say up to £3m) should be funded through business plans. For larger projects, only those with a sound business case that may be assessed by Ofgem on an individual basis should be funded in this way. More speculative larger projects are better funded through the innovation stimulus where, through competition, only the best projects are awarded funding.

The business plan expenditure should not be expected to be totally made up of named and specified projects. A well-justified budget cost should be acceptable due to the difficulty in planning of individual projects for a price control now spanning eight years in duration. Also it is appropriate for companies to adopt a “probe and learn” type behaviour in order to define and implement follow-on projects as the need is identified through the learning outcomes of existing work. Future innovation needs will emerge in the course of a price control period and the framework for allowing innovation in business plans should support this natural evolutionary thinking.

In electricity distribution, the innovation framework encompasses smaller-scale research and development, as well as smaller and larger network trials. The current mechanisms are the innovation funding incentive and the first and second tiers of the low carbon networks fund respectively. In transition to a new innovation stimulus package of incentives we need to ensure that this full coverage of innovation at the various technology readiness levels is maintained. We are seeing, and expect to continue to need, good ideas being developed in projects that move through these different stages from drawing board to widespread commercial deployment. This coverage of the different stages of innovation is equally needed in the other networks sectors.

The general principles applicable to innovation in both business plans and the innovation stimulus should be that collaboration is encouraged and intellectual property rights are shared.

Approach to stakeholder engagement and the key milestones highlighted

We support the use of an innovation stimuli working group to develop the proposals further. We have nominated a representative and hope to use our experience of helping to develop the low carbon networks fund to benefit the implementation of the wider innovation stimuli.

The milestones suggested by Ofgem appear sensible.

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

Jim Cardwell
Head of Regulation & Strategy