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Dear Anna

It is clear to all of us that the transition to a low carbon economy presents a range of challenges to Britain's gas and electricity industries. Innovation is part of the solution and it's important to establish how innovation will be funded in regulated networks businesses using the RIIO model for sustainable regulation. It is appropriate to develop the Innovation Stimulus package through a series of working groups as Ofgem proposes, building on the experience gained from both the Innovation Funding Incentive (IFI) and the Low Carbon Network Fund (LCNF).

Before turning to the specific questions asked in the open letter, it is worthwhile to reflect on both the existing innovation mechanisms in electricity distribution. IFI was subject to very little discussion during DPCR5 negotiations. This was because all parties agreed that IFI was a successful and effective mechanism for funding R&D. The *strengths* of the IFI mechanism include the breadth of scope and the regulatory governance appropriate to the size of the allowance. The *benefits* of IFI include the development of skills and knowledge within the network operators and the stimulation of the research supply chain.

The current IFI arrangements are working extremely well and have engendered a beneficial collaborative approach between network operators, suppliers, universities and research establishments. The collaborative culture has led to numerous dissemination events and other information sharing between interested parties which has extended learning and has avoided wasteful project duplication. Collaborative arrangements have enabled the funding of innovative projects with low technology readiness levels which otherwise would have been considered too risky, low benefit, or too long term and has also allowed the combined network operators' expert advisory resources (which are



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limited) to be shared to best advantage.

Tier 1 of the LCNF has only just started and it seems that several former IFI projects are progressing via this route to higher readiness levels. Tier 2 of the LCNF has yet to complete its first bidding cycle, and although the process will be refined it is clear that this mechanism will facilitate innovation in terms of larger scale trials.

The type of innovation required in electricity transmission, gas transmission and gas distribution is best identified by the companies operating in those sectors. It does however seem likely to include the use of biogas, the use of gas assets to transport carbon dioxide and commercial and practical arrangements to operate demand side measures.

The level of funding for LCNF appeared to be set on an empirical basis which took into account the type of innovative projects it sought to encourage. Similarly the level of funding in each sector should take into account the type of projects envisaged in that sector.

Experience suggests that some innovative projects could be included in business plans rather than compete for funding through the stimulus package. Projects which could be included in business plans could have characteristics such as;

- only an incremental risk when compared to business as usual,
- limited technical innovation,
- conceived in partnership with one or more customers,
- investment ahead of need but with a strong likelihood of stimulating utilisation,
- limited financial scale.

Inclusion of such projects in business plans would represent a progressive regulatory approach; similar inclusions were removed from DPCR5 business plans. The stimulus package should cater for large scale demonstration projects with notably higher risk than business as usual.

The case for granting third party access to networks and creating a new license remains unconvincing. No evidence has been presented that suggests network operators are ignoring good ideas put forward by third parties. It is difficult to see how third parties would be able to identify which part of the network has a particular problem, and therefore know where to trial a solution, or be responsible for safety and security of supply. These significant considerations notwithstanding, third party licensed innovators would probably end up demonstrating solutions on test networks or non representative locations, limiting the relevance and learning. A scenario in which a third party innovator forms a partnership with the network operator is likely to be much more successful.

I hope that the thoughts set out in this letter are useful in setting out to define the Innovation Stimulus package under RIIO. The present IFI arrangement is very effective in promoting R&D at an appropriate capped level, and it should be accommodated in the RIIO approach to innovation. If you wish to discuss or clarify any of the points in this letter then please contact me.

Yours sincerely

[by email]

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