Consumer Focus
Campaigning for a fair deal

23 November 2010

Anna Rossington
The Office of Gas and Electricity Markets
9 Millbank
London
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Dear Anna,

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

Consumer Focus is the independent champion for consumers across England, Wales, Scotland, and for postal consumers in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do.

The focus of our response is on answering two questions provided by Ofgem at the stakeholder event held on 15 November 2010.

1. How should the annual level of funding to facilitate innovation in each sector compare to the £64 million available annually under the LCNF? How should funding be profiled over the eight year period of the RIIO price control?

We note that the innovation stimuli stakeholder event revealed there was a wide range of views on the appropriate level of funding. Some market participants argued that the current level of funding under the Low Carbon Networks Fund (LCNF) was adequate. Other stakeholders argued that greater levels of funding were required. To support this view some parties pointed out that Tier 2 funding under Distribution Price Control Review 5 (DPCR5) was more than three times oversubscribed.

Our view is that the level of funding should meet the level required to meet agreed outputs, which we admit is more easily said than done. However, we would say that just because Tier 2 funding was oversubscribed is not a conclusive argument for a higher level of funding as this oversubscription says nothing about the quality of the projects being pitched to Ofgem. To help Ofgem determine the correct level of funding we think it would be wise for the regulator to learn lessons from the LCNF experiment. If there is any doubt about the level of funding required we would urge Ofgem to play it safe and propose a similar level of funding as was agreed under DPCR5. Other innovation projects would then be funded under the normal RIIO (revenue=incentives + innovations + outputs) framework.

On the profiling of funding over the price control period, we are fairly relaxed that funding is flexible within the period ie varying amounts year on year. We can see the benefits of ensuring that funding is available to beneficial projects when they are in a position to be implemented rather than waiting artificially for the following year when funds will be available.

Finally, we agree that the stimuli should be a time limited one. Ofgem might like to consider a review date for understanding the efficiency of the stimuli and whether the RIIO model is capable of incentivising networks to be more innovate without recourse to a separate innovation stimulus.

2. What speculative investment should companies include in their business plan to be funded through the price control (versus what they should compete for through the stimulus)? What should be the potential value of this speculative investment? What justification should be required within the business plan?

We believe that a good first principle for deciding what speculative investment should be funded by the stimulus as opposed to the price control has already been provided by Ofgem. This is ‘to encourage innovation in the provision of network services related to the delivery of a sustainable energy sector that may not develop in the absence of the innovation stimulus package’. If the innovation stimuli can provide this, it will be judged a success. However, where to draw the line between projects which are funded via the two different routes will be a difficult task.

As a starting point we believe that the scope for including projects in the business plan, to be funded by the price control, should be as wide as possible. It would seem that innovation projects which have a clear commercial basis or small speculative projects would be best funded under the price control. These projects should be able to demonstrate in the business plan where the network will be able to make a return and deliver benefits for consumers.

It is essential that qualifying criteria for the innovation stimuli is provided by Ofgem to ensure that the bids submitted are appropriate. Such guidance should also be useful to industry in terms of not wasting internal resources on bids which are obviously inappropriate. As a starting point, we think that the following requirements/conditions need to be met for projects to be considered for the innovation stimuli:

- The relative risk/reward ratio must be clearly presented. Only projects deemed high risk with large benefits for end consumers or at least the potential to deliver this (masked by the speculative nature of the project) should be considered for the stimuli
- The upfront cost of the project must represent a significant barrier to investment
- Network companies should demonstrate that the project initiated under the price control would be commercially unviable on a Net Present Value basis. However, we would caution Ofgem on relying too heavily on this measurement as it might just mean that the project is unlikely to be cost effective
- The benefits to the individual network company might be less than the benefits to consumers as a whole. This must be demonstrated if the case
- Any benefits for consumers which might accrue beyond the price control period should be demonstrated

While we welcome the fact that the innovation stimuli should be devoid of ‘benefits of hindsight adjustments’ we would like to understand the possibility of introducing some downside incentives (as well as upside incentives) to project managers. This could come in the form of performance-related loans. Such incentives would be in place at the time the project was agreed and should ensure that the project managers are not completely de-risked (and therefore placing all risks on to end consumers). However, we accept that this would only work if the outputs of the projects were known before the project begins. Incentive mechanisms where the outputs are unknown could place a barrier to the type of innovation we would hope to incentivise.

We think that the innovation stimuli should be open to as broad a category of market participant and innovation type as possible. We want to ensure there isn't any unnecessary bias between different 'types' of innovation eg skills development, technical etc, and that cross sectoral innovation is not unfairly prejudiced against. It is also important that the stimulus is open to projects at all points in the innovation cycle and that information discovered is diffused to market participants (as the consumer has largely underwritten the risk of the investment).

We want to ensure that there is a regulatory tool which will allow third parties to undertake innovation thus increasing competition, despite the misgivings which were aired by many at the stakeholder event. We are keen to ensure that funding available under the stimuli is not a 'closed shop' to anyone outside the network companies.

Finally, we note the concerns raised by some market participants that there is the potential for 'picking' fuel types by having separate innovation stimuli for gas and electricity which could lead to differentiated levels of funding. We recognise this is a problem that regulators always face ie unintentionally 'picking winners' rather than letting the market decide the 'least cost' option. It might be useful for Ofgem to relate the stimuli back to outputs thus allowing electricity or gas networks/third parties to provide solutions to problems related to the delivery of heating, lighting etc regardless of fuel.

I hope these comments are helpful. If you would like to discuss them further I would be happy to follow them up with you either in person or via telephone/email (**cem.suleyman@consumerfocus.org.uk**, 020 7799 7932).

Yours sincerely,

Cem Suleyman

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