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Dear Anna

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

Further to your letter of 12 October 2010 regarding the development of the innovation stimuli we welcome the opportunity to set out our views of your proposed approach to innovation funding under the RIIO model. In doing so I will draw upon our experiences of the current innovation funding arrangements available to licensed distribution network operators, namely the Innovation Funding Incentive (IFI) and Low Carbon Networks Fund (LCN Fund).

We support your overall proposal to deliver two streams of innovation funding for network operators: an innovation funding stream available within the price control settlement accessed as part of the business plans of the network operators (nominally similar in concept to IFI or Tier 1 of the LCN Fund); and a second innovation funding stream accessed via competitive call available to network operators and appropriately licensed third parties (nominally similar in concept to Tier 2 of the LCN Fund). We note that the current financial support for the development of Tier 1 and Tier 2 LCN Fund projects with an allocated percentage of Tier 1 allowances has had a positive effect on the behaviour of the network businesses. This financial support for development of projects should continue in the future. We welcome the proposal to include third parties within the innovation framework of RIIO as we recognise that the networks sector does not have the monopoly on new ideas. Opening up innovation development to third parties will attract a broader range of companies to participate, but prospective third parties should be required to demonstrate that they are able to undertake innovation projects on networks in partnership with network businesses and they are able to disseminate the learning generated in a manner that makes it usable by the networks businesses.

Innovation funding should not be restricted to developing a sustainable energy sector or the transition to a low carbon society. Recognising the success of the IFI scheme, it must be available to support innovation across all the activity areas of network operators (for example customer service, environmental impact etc.) and should cover all aspects of the innovation cycle from research and development through to deployment. This enables network operators to target change in the areas of technology and commercial and operating arrangements that deliver value for existing and future customers.

The size of the innovation stimulus investment should be proportionate to the size of the challenge faced by the network operators. Ofgem identified in the development of the RIIO methodology that network operators will collectively invest significant sums by 2020 to provide

networks required for a low carbon society and to maintain security of supplies. It seems appropriate that the current level of investment in innovation is increased to at least 3% of the turnover of the networks businesses to drive innovation across the sector. Electricity distribution businesses arguably face the greatest challenge of all those companies within the network sector with the requirement to facilitate the connection of new electricity demands (for example from electric vehicles and electric heating) and the increase in connection of electricity generation (driven by the Feed-in-Tariffs). Electricity network operators must engage with customers to deliver new solutions that integrate the customers' requirements at most efficient investment cost and so we would expect to see a greater proportion of the innovation funding made available to the electricity distribution network operators.

The network operators have demonstrated that they can and will utilise innovation funding, for example IFI has been a success both for network operators and customers. We propose the ratio between innovation funding within the price control settlement and the competitive call process seems appropriate at a level of one to four, thereby providing a stimulus for network operators and wider opportunities for all. We are concerned at the proposal to ring-fence an element of the innovation stimuli specifically for commercial arrangements. This creates an inappropriate artificial driver. If the development of commercial arrangements provides value to licensees and customers then companies will target this area and a cap may restrict innovation. We suggest that initially there is no ring-fencing of the innovation funding for commercial arrangements, but if a need is identified from experience then restrictions can be applied later in order to steer the innovation of the networks sector.

Ofgem recognised in the development of the RIIO model that network operators face significant challenges to assist in the development of a sustainable energy sector, we are therefore surprised that Ofgem has chosen to make the innovation stimuli time – limited. Between now and 2050 each decade will provide a differing set of challenges on the journey to reduce carbon by 80% by 2050 and so we do not see a decline in the need for investment in innovation.

We will continue to support the development of the innovation stimuli for gas and electricity network operators by actively contributing to the debate and discussion in the recently convened innovation stimuli working group.

If you wish to discuss any of the points raised please do not hesitate to contact me.

Yours sincerely,

Paul Bircham
Customer Strategy and Regulation Director