



Electricity distribution operators, consumers and their representatives, generators, suppliers and other interested parties.

Promoting choice and value for all gas and electricity customers

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Reference: 167/10

Date: 20 December 2010

Dear Colleague,

Impact of the Interruptions Incentive Scheme (IIS) on Second Tier Low Carbon Networks (LCN) Fund projects

Background

On 3 November 2010 we issued a statutory consultation¹ which outlined our intention to amend Distribution Network Operators' (DNOs) licences in order for specified activities undertaken as part of an LCN Fund Project to be protected from the IIS penalties. Under the IIS, DNOs are encouraged to deliver a good quality of service and reduce the number, duration and impact of supply interruptions by exposing them to rewards and penalties for interruptions performance against set targets.

Granting an exemption from the IIS penalties for second tier LCN Fund projects would weaken a scheme intended to drive improvements in service to customers and which relates the price customers pay for the level of service they receive. Consequently, prior to taking any decision following our statutory consultation, we are consulting more broadly on how we should treat IIS penalties associated with LCN Fund projects. This consultation only applies to projects funded under the second tier of the LCN Fund since projects under the first tier are unlikely to be large enough to incur significant IIS penalties.

The IIS

Through the IIS DNOs are incentivised to reduce the impact of supply interruptions by exposing them to rewards and penalties for their interruptions performance against set targets. These targets recognise the fact that supply will be interrupted on occasions as part of normal operations. However, if DNOs exceed these targets then they are penalised. The penalties and rewards are funded by adjustments to the allowed revenue DNOs can recover from their customers. If they are penalised, their allowed revenue decreases, if they are rewarded their allowed revenue increases. This helps to ensure that customers pay for the quality of service they receive from their DNO.

The IIS scheme recognises that as part of good business practice, DNOs will need to switch off consumers from time to time – for example in order to maintain equipment. These interruptions are planned, with advance notice given to customers to limit the inconvenience. DNOs' revenue exposure under the IIS ranges from £4m to £7m per annum².

¹ <http://www.ofgem.gov.uk/Networks/ElecDist/QualofServ/QoSIncent/Documents1/Section%2011%20Mod%20-%20CRC8%20Final.pdf>

² Calculated from tables A3 and A6 in charge restriction condition (CRC) 8 of the electricity distribution licence.

The LCN Fund

The future use of the electricity distribution networks could change considerably as we move to a low carbon economy. This could require significant changes in the way the networks are designed and operated, and the commercial role the DNOs play in the overall supply chain.

With this in mind, we created the £500m LCN Fund to encourage the DNOs to try out new technologies, operating practices and commercial arrangements which have the potential to help meet these challenges. A key feature of the LCN Fund is that learning gained from projects must be shared with all other DNOs and interested third parties, in order that all customers gain significant return on their funding through innovation which brings network savings and/or carbon benefits.

Some of the innovation trials funded through the LCN Fund may involve installing new equipment which would require customers' electricity supply to be interrupted. These would be planned interruptions, meaning that customers get advanced warning to limit the inconvenience. There is also the risk that during some trials, a new piece of technology or an operating arrangement may not work as planned, resulting in an unexpected (unplanned) interruption.

The LCN Fund comprises of a first and second tier funding mechanism. The first tier funding mechanism provides up to £80m across a five year period which is paid directly to all DNOs. It is designed to fund a large number of small scale projects. The second tier funding mechanism provides up to £320m across the five year period. DNOs submit projects which compete for an annual funding allowance of up to £64m. As stated above we consider that projects under the first tier are too small to incur significant IIS penalties.

Should LCN Fund projects be protected from IIS penalties?

We welcome respondents' views on whether projects funded under the second tier of the LCN Fund should be protected from IIS penalties and whether this protection should apply to all interruptions or only planned interruptions.

In addressing this question, we have considered the impact on the rate of innovation, the overall impact on customers and whether there is any relevant precedent. We have also considered how we would apply any protection from IIS penalties.

If LCN Fund projects are not protected from associated IIS penalties this may discourage DNOs from proposing projects which might entail interruptions (either planned or unplanned). This may stifle the innovation which we have identified is required in order for the distribution networks to facilitate the transition to the low carbon economy.

Ofgem's principal objective is to protect the interests of existing and future customers. The IIS plays an important part in the regulatory arrangements through making DNOs think about the impact on customers of supply interruptions and through ensuring that customers only pay for the quality of service they receive. However, the LCN Fund also plays an important role in protecting the interests of existing and future customers. The trials it funds should provide knowledge for all DNOs which will enable them to create the networks required as GB moves towards a low carbon economy. Consequently, we consider that successful LCN Fund projects can provide considerable customer benefits.

A number of existing voluntary schemes are not exempt from the IIS. These include projects to improve service to the worst served customers, the undergrounding of lines in areas of outstanding natural beauty and registered power zone projects. However, projects under these schemes are much smaller in scale than LCN Fund projects have the potential to be, and therefore would have less financial impact on DNOs in terms of the IIS penalties they generate. We would also highlight that the benefits of LCN Fund projects are likely to be larger and accrue to all GB customers.

If it was decided following this consultation that DNOs should be protected from IIS penalties associated with LCN Fund projects, the Expert Panel³ and the Authority will assess the impact on customers and size of penalty to be exempted as part of the project evaluation, in order to compare the project against the other competing projects on a like for like basis. In their project submissions DNOs will have to identify:

- potential interruptions, including the size and duration of the impact and the potential IIS penalty, and
- whether, if the project is successful, the subsequent roll-out of the project would incur similar interruptions and therefore what the total impact on customers would be.

Additionally, we would make any protection conditional on the DNO concerned:

- demonstrating to us that these interruptions could not be reasonably avoided or mitigated, and
- providing us with a detailed plan of how customers will be informed and handled (including how vulnerable customers will be treated).

An important principle is that the DNO would not be protected from any and all IIS penalties associated with the project, but only those associated with the activities identified as requiring protection in the project submission. This is in order to ensure that the DNO is still incentivised to operate its business to normal business standards where an LCN Fund project is being deployed.

Options for protecting LCN Fund projects from IIS penalties

We welcome respondents' views on the best way to implement protection for LCN Fund projects from IIS penalties (if appropriate).

If we conclude that LCN Fund projects warrant protection from IIS penalties, we have a number of options, as set out below.

Option 1: Fund project IIS penalties through project funding.

This option would require DNOs to make an estimate of the value of the IIS penalty associated with their project, and include the penalty amount in the funding they request from the LCN Fund. If the project went ahead, the company would pay IIS penalties in the normal way, having received financial compensation for the estimated penalties associated with the project, through the LCN Fund.

This option would enable the full cost of the project to be considered on a consistent cost basis with those which did not involve customer interruptions. It will also provide a strong incentive on the DNO to do all it can to prevent interruptions associated with the project exceeding the forecast level that has been funded through the LCN Fund. This option means customers in the rest of the country - who have the potential to benefit from the project - will fund the IIS penalties as part of their contribution to the project cost. These penalties will result in marginally lower charges for customers in the distribution area in recognition of the lower service delivered as a result of the interruptions.

Whilst this approach might encourage a DNO to over-estimate the level of interruptions (in order to ensure financial protection from all potential IIS penalties) the DNO would need to balance this against the need to submit a cost effective proposal which can compete against other projects for funding and pass the detailed scrutiny of the Expert Panel and Authority.

It should be noted that under this option if the DNO achieves a lower level of interruptions than the amount set out in its submission, it is not able to keep the additional amount funded through the LCN Fund, since all amounts remaining at the end of a project must be returned to customers.

³ An independent panel of experts recruited by the Authority to make recommendations to the Authority on which projects should be selected for Second Tier funding.

Option 2: Fund project IIS penalties through the discretionary reward.

This option would require the DNO to log-up IIS penalties associated with the project. Those which we deemed to be justifiably incurred would then be funded at the end of the project through the discretionary funding mechanism of the LCN Fund.

The IIS penalty would be met by the DNO - and those customers in the distribution area affected by the interruptions would receive marginally lower distribution charges. After project completion, the DNO would be eligible to receive a payment through the discretionary reward to cover efficiently incurred penalties. They will only receive this reward (including an element to compensate them for IIS penalties) if they deliver the project successfully.

The discretionary reward payment is funded by all GB customers in the same way as the LCN Fund project funding. Consequently, this maintains the principle that customers who have the potential to benefit from the project will fund the IIS penalties whilst customers within the DNO area where the trial is taking place will face marginally lower distribution charges to reflect the reduced quality of service which some of them had experienced. In addition, this option enables us to retrospectively assess whether the level of customer interruptions were justifiably incurred. Any penalties associated customer interruptions which we deemed were unjustifiable would not be funded.

Implementing this option would require changes to be made to the LCN Fund Governance Document, particularly to expand the scope and increase the limit of the successful delivery reward.

Option 3: Exempt project interruptions from IIS penalties.

Under this option, the activities which DNOs identified as requiring protection in their LCN Fund project submission would be exempted from IIS penalties by amending the licence, as per the earlier statutory consultation.⁴ In recognition that this would remove the incentive on DNOs to limit the interruptions associated with the activities, we would require DNOs to include the proposed level of interruptions within their successful delivery reward criteria. The DNO is rewarded under the LCN Fund for meeting the successful delivery reward criteria, meaning the company is incentivised to meet or beat the target level of interruptions.

This option would mean that the DNO would face no IIS penalties associated with the LCN Fund project and consequently, customers within the DNO area will not receive marginally lower distribution charges to reflect the reduced quality of service that some of them had received.

Option Comparison

The statutory consultation we issued on 3 November set out the licence condition changes required to implement option 3.⁵ However, following discussions during the consultation we are mindful that an approach which preserves the relationship between customers' charges and the quality of service they receive from DNOs would offer a more equitable approach. Options 1 and 2 maintain this principle, while the licence change approach does not.

When comparing options 1 and 2, the latter enables the efficiency of the interruptions to be assessed ex post whereas the former keeps a strong incentive on the company to keep interruptions to the levels estimated in the project documentation. Of these two options we consider option 1 to be preferable.

⁴ We considered the alternative option of changing the licence to identify certain LCN Fund activities as adjustments of performance on quality of service targets under Part K of CRC 8. This option was discounted because it would require an audit and direction setting out exempted interruptions for each year of the project. We considered this disproportionate.

⁵ <http://www.ofgem.gov.uk/Networks/ElecDist/QualofServ/QoSIncent/Documents1/Section%2011%20Mod%20-%20CRC8%20Final.pdf>

Current LCN Fund projects which require exemptions

On 29 November, we published our decision on the projects that will receive second tier funding in the first year of the LCN Fund.⁶ Two of the projects selected – Low Carbon London (UK Power Networks) and LV Network Templates (Western Power Distribution) involve customer interruptions.

If, following this consultation, we conclude that LCN Fund projects should be protected from IIS penalties, there is a question over how we apply our preferred approach to the projects selected this year. We cannot apply option 1 as set out above since the cost of the IIS penalties were not included in the level of funding requested (it was not a requirement in the LCN Fund Governance Document). However we would note that although the cost was not included as part of the project request, the Expert Panel and Authority were aware of, and took into account in their decision, the potential interruptions arising and the financial cost of the penalties.

Therefore, there are two options on how we could provide IIS penalty protection for projects in this first year of the LCN Fund:

Option A: Use the discretionary reward funding mechanism to fund the IIS penalties

This is identical to option 2 above. Implementing this option would require a change to the LCN Fund Governance Document. If we do not want to implement option 2 as the enduring solution for future years it means that this governance change is only required for the first year. Whilst this may be untidy, we would be explicit in the revised Governance Document that the revised arrangements would only apply for first year projects. However, DNOs submitted projects this year on the basis of the discretionary reward funding mechanism outlined in the governance document at the time. We are particularly interested to understand if this option would cause a concern to any of the other companies that participated in this years' LCN Fund competition.

Option B: Exempt the project interruptions from IIS penalties

This is identical to option 3 above but would only apply for the two DNOs identified above. Again, if a different enduring solution is implemented, then this exemption would not be extended to any other company with a winning second tier LCN Fund project. However, this is a relatively simple way in which to provide protection against IIS penalties for the projects and to ensure that they proceed and potentially deliver the learning and benefits which have been identified.

We welcome respondents' views on which of the above options should be implemented for this year's LCN Fund projects.

We welcome views on any of the issues set out in this letter. Please submit responses by **24 January 2011**. Unless clearly marked as confidential, responses will be published on our website. Please email responses to anna.rossington@ofgem.gov.uk. If you have any questions in association with this consultation, please contact Anna Rossington on 0207 901 7401.

Yours faithfully,

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⁶ http://www.ofgem.gov.uk/networks/elecdist/lcnf/Documents1/LCNFunddecision_Final.pdf