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Dear Anna

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

Scottish and Southern Energy plc (SSE) and Scotia Gas Networks plc (SGN) welcome the opportunity to comment on Ofgem's open letter consultation on the development of gas and electricity innovation stimuli. In particular, we support Ofgem's initiative in this respect and believe that network innovation in the coming years will be key to achieving a sustainable energy sector.

We agree with Ofgem that non network third parties have an important role to play in the field of innovation, however, we do not believe that it is appropriate for them to do so without direct network involvement. **Where technologies are to be developed on active networks, the network owner must be an active participant.** The network licensees own and have ultimate responsibility for their network assets and, as such, have a particular responsibility for safety and security of supply bestowed upon them by virtue of primary and secondary legislation and their particular licences. It would therefore be a great concern to us if Ofgem were to grant third parties particular "rights" to these networks.

It will also be essential to ensure that the new stimuli build upon the good work that has already been achieved through the existing network Innovation Funding Incentive (IFI) and more recently, the introduction of the Low Carbon Network (LCN) fund for electricity distribution networks. In particular, **we believe that a role remains for the IFI to run in parallel**.

We expand on these two key points in more detail below.

Role of third parties

As already stated, we do not believe that it is appropriate for Ofgem to progress third party participation via the granting of licences. We also question the efficiency of doing so. History shows that the creation of a new category of licensee, the development of the associated licence and the integration of these parties into the existing regulatory and commercial framework (via code modifications etc.) takes time and has a significant cost associated with it.

Accordingly, on the grounds of efficiency, we do not believe the case has been made for proceeding with this aspect of the stimuli, particularly since the stimuli (and therefore the proposed new licence category) is to be time limited.

Nevertheless, as we have already indicated, we agree that third parties have a valuable contribution to make. We therefore propose that non network third party involvement is provided for as working partners with network organisations. In this way, networks and third parties work together pooling relevant "specialist" information and expertise to provide an optimum innovation opportunity whilst maintaining customer safeguards. To date, this approach has already proved very successful for IFI and LCN fund initiatives where a number of big, strategic partnerships have been forged. For example, SGN's partnership with British Gas and Thames Water in the research, design, development, construction and commissioning of the first UK facility to produce biomethane at Didcot for injection into the gas distribution network.

We are not aware of any third party being denied participation in either of the existing innovation initiatives. We therefore see no reason why Ofgem believe it should be an issue under the new stimuli. In our view, a more proportionate, appropriate and efficient way forward would be to proceed on the presumption that non-network third parties will be able to participate in the stimuli under the existing regulatory framework. But to address Ofgem's potential concern, there might be introduced a provision that would allow third parties a "right of appeal" to Ofgem in the event that they believe they are being inappropriately denied the opportunity to work with a network. In our view, this would also be more aligned with "light touch" regulation.

As we have indicated, we support the concept of the innovation stimuli in the knowledge that it is to be progressed as a competitive framework along the lines of the LCN fund. As such, it will be important to ensure that there is a level playing field. This is particularly relevant for electricity transmission where National Grid provides the National Electricity Transmission System Operator (SO) function as well as being the owner of the transmission system is England and Wales. As such, in its role as SO, National Grid will (in all likelihood) have a requirement to be aware of and "passively" involved in a number of transmission owner (TO) innovation initiatives, including those associated with its own TO’s competitors. Similar concerns may arise in gas where National Grid Gas owns a number of Gas Distribution Networks and also provides the GB Gas SO function that may, in certain circumstances, have a requirement to be passively involved with projects associated with its own GDNs’ competitors. Consequentially, confidentiality between the system operation and network owner functions within National Grid will need to be addressed for both the gas and electricity stimuli.

Since it appears that distribution and transmission initiatives will be competing for the same pot of money but where the characteristics of such projects are likely to be very different, it will also be important to consider, and fully understand, how projects of different size and nature will be assessed in the competitive environment. For example, consideration will need to be given to the proportion of “own company” funding where the scale of initiatives might be very different.

Interaction with existing mechanisms

Ofgem has stated that the innovation stimuli is to encourage projects where the commercial benefit of the innovation may not be clear. Accordingly, as previously mentioned, to ensure that less “risky” projects are not precluded we firmly believe that the innovation stimuli should build upon the existing IFI and LCN innovation schemes. In our view, the competitive innovation stimuli should be implemented in addition to the IFI arrangements to provide maximum flexibility and scope to innovation as we move into this critical period of network development. In essence, we believe that there should be a three tier approach to innovation: well justified business plans; regulated IFI-type arrangements; and the competitive innovation stimuli. We expand on this in more detail below.

As we see it, the well justified business plans submitted by the network companies provide the opportunity for networks to “pitch” for specific, ex ante funding for justified, relatively certain and low risk innovative projects. However, there will also be other as yet unspecified, or indeed unknown, projects/initiatives that a network will want to progress during the price control period that are not best suited to progression under the competitive funding route. In our view, it will be essential to ensure that the price control framework allows these projects to progress within period and that suitable mechanisms exist to allow networks access to an appropriate level of funding as and when these initiatives arise.

We therefore believe that alongside the competitive innovation stimuli funding route, an IFI-type funding mechanism should co-exist. In fact, we would go as far as to say that the absence of this would pose a significant risk of limiting the diversity of innovation. For example, the treatment of Intellectual Property (IP) rights is very different for IFI schemes compared to those that will fall under the innovation stimuli. Therefore, unless a mechanism exists to accommodate projects where IP rights are a particular issue, there is a significant risk of excluding those potentially valuable projects. The absence of an IFI-type mechanism will, in all likelihood, mean that other valuable ideas may not be progressed, such as small projects; those related to safety; and those that provide funding to other parties such as universities.

In our view, the IFI mechanism has provided a valuable feedstock for LCN fund projects and we expect it to do the same for the innovation stimuli (particularly where, at the start up phase, IP is an issue). It would be most unfortunate if this source of innovative ideas that would ultimately move to the competitive arena were removed.

We recognise that governance arrangements around the access of IFI type funding would need to be considered including project eligibility criteria; the size of pot to be drawn upon; and how the pot is allocated to individual networks. Again, it will be necessary to ensure that small networks such as SHETL are not disadvantaged. We note that this SHETL-specific issue was considered and accounted for in the TPCR4 IFI mechanism.

Turning now to the areas that Ofgem has particularly respondents to comment on.

1. 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.

Within the electricity and gas sectors, it will be essential that innovation initiatives are developed that fit with the bigger picture of what is happening in GB as a whole. Furthermore, it is apparent that innovation within the respective distribution sectors, and also within the supply sector, will more often than not have meaningful impacts on transmission and indeed could be drivers for change. We therefore believe partnerships between TOs and distribution networks are likely to be a key feature of the new regime. A good example of this has already occurred within SHEPD "NINES" project where SHEPD has partnered National Grid in a LCN fund proposal to facilitate learning for the whole GB grid and distribution networks under the LCN framework. A further area of interest would be concurrent management of distribution and transmission constraints. We would therefore expect more of these kinds of relationships to develop going forward, and the mechanism should be sufficiently flexible to accommodate, and indeed reward, such collaboration.

One area of likely innovation will be to understand how a multitude of small changes on the distribution networks (such as the installation of small photo-voltaics, electric car charging points, embedded biomethane production etc.) are reflected on the transmission networks and how these contribute to the overall decarbonisation of the networks. Such interactions are likely to require far more than gathering vast of quantities of data samples. It is likely to require new and sophisticated modelling and in depth understanding of interactions that do not presently exist. Another facet of this is developing a better understanding of asset utilisation in order to optimise its use. Initiatives in this area could include exploring new and alternative storage devices and facilities; dynamic tariff setting; the creation of new dynamic commercial relationships; and new technologies e.g those in electricity that allow the passage of greater power as and when called upon and, in gas, those that provide greater control of pressure and reduction in leakage.

2. How the annual level of funding to facilitate the innovation in each sector would compare to the £64m available annually under the LCN fund.

It is clear that the funding available under the new stimuli must provide an appropriate stimulus and opportunity for companies to break new ground and address the challenging issues that face the sector. We see the innovation stimuli as addressing larger, higher risk, long term and more collaborative initiatives that, by their very nature, are likely to be capital intensive. As such, the level of required funding will be significant. However, at this stage it is hard to form a view on an appropriate annual level of competitive funding to facilitate this in each sector. We note that the £64m referred to by Ofgem relates only to the competitive element of the LCN fund and that a further £16m per annum is effectively split between DNOs on a use-it-or-lose-it. This is in addition to the IFI scheme. Therefore, in our view, the size of the innovation stimuli fund will necessarily depend upon the extent to which other funding mechanisms within the price control have been provided for. We also believe that there is a requirement to have some flexibility in the size of the fund.

The fund should also be sufficient to allow meaningful rewards to be given to projects that receive innovation stimuli funding. In our view, this will become increasingly important once the initial impetus of innovation resulting from the competitive aspect of the stimuli naturally declines.

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

Clearly, as the proposed stimuli are to be competitive, we would not want to reveal our detailed views on possible projects at this stage.

4. 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 stimuli and the potential value and required justification for this speculative investment.

In providing comments on this area we do so in the context of innovation and not in the wider context of speculative (or "anticipatory") investment in respect of the provision of infrastructure which is being considered elsewhere within the RIIO-T1 discussions.

Hitherto, speculative investments have not been part of past price controls and would therefore need to be carefully managed to ensure customers' interests were protected going forward if this were to change. However, we see no reason why Ofgem should not consider this as part of the upcoming settlement in the context of innovation and in the interest of progressing innovation more quickly than would otherwise be the case. At a high level, we believe that only low risk projects should be included in the business plans themselves and that these should be well justified in terms of a quantified needs case. We would envisage that medium risk projects would fall into the IFI-type mechanism and high risk, high cost projects should be progressed via the innovation stimuli.

We hope that you will find these comments useful and we look forward to participating in the development of the innovation stimuli over the coming months.

Yours sincerely

Aileen McLeod

Regulation Manager