



To transmission companies,
distribution companies, generators,
suppliers, shippers, customer
groups and other interested parties

*Promoting choice and value for
all gas and electricity customers*

Your ref:
Our ref: 07/11
Direct Dial: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

Date: 21 January

Dear Colleague,

Open letter consultation on non-network company access to the innovation stimulus

This letter seeks views on options for giving third parties (non-network companies) access to funding aimed at stimulating innovation on Great Britain's energy networks.

Gas and electricity networks face significant challenges in facilitating the move to a low-carbon economy and in meeting the UK's renewables targets¹. Networks will need to be smarter to encourage customers to manage their demand and to integrate increasing local and intermittent renewable gas and electricity sources. To achieve this, the degree of innovation on networks will need to increase significantly. For this reason, there are a number of measures for encouraging innovation in the new RIIO framework we have established for regulating gas and electricity networks².

An important part of the RIIO framework is the innovation stimulus, a time-limited initiative to encourage technological, operational, commercial and charging innovation related to energy networks. Partial funding for projects will be awarded annually through a competitive bidding process. The innovation stimulus will provide funding for projects related to GB gas and electricity transmission and distribution networks and will adopt many of the principles of the Low Carbon Networks (LCN) Fund³ that we set up this year to fund innovation in the electricity distribution sector. However, third parties are unable to compete directly with electricity distributors for support from the LCN Fund. In designing the innovation stimulus we are looking to explore what mechanisms we should use to allow third parties access to funding. This open letter is the first stage in that process.

In October last year we consulted on the governance and funding arrangements for the innovation stimulus (ref. 129/10)⁴. Responses to that consultation informed a set of proposals in our initial strategy documents for the price control reviews for gas distribution and electricity and gas transmission networks⁵. Consultation on those proposals closes on 4 February 2011.

¹ The UK has signed up to the EU Renewable Energy Directive, which includes a UK target of 15 per cent of energy from renewables by 2020.

² (Revenue = Incentives + Innovation + Outputs). See the Ofgem website for further details at <http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx>

³ Further information on the LCN Fund is available at: <http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Pages/lcnf.aspx>

⁴ October open letter (ref 129/10) available at: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=285&refer=Networks/Policy> our

⁵ Initial Strategy for RIIO T1 and RIIO GD1 available at: <http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/T1%20and%20GD1%20BP%20prop.pdf>

Our intention is that the innovation stimulus should come into effect for transmission and gas distribution networks from 2013 at the start of the new price control period for those network sectors. The LCN Fund will run until 2015, at which point innovation funding for electricity distribution network projects will be incorporated into the innovation stimulus and third party access arrangements will be consistent across all sectors.

Current legal framework

In common with the LCN Fund, the innovation stimulus will rely on transfers of funds from network companies to the projects that are successful in the annual competition. However, under existing primary legislation, money raised from network companies through price controls can only be transferred between those holding network licences⁶. Without a licence, third parties cannot directly access funding by leading bids or projects⁷. Their participation in the LCN Fund for example, is limited to joining partnerships or consortia led by the network companies.

We are concerned that these limitations could restrict third-party involvement in network innovation. This could reduce the degree of competition for innovation stimulus funding and/or limit the type of innovation projects submitted to the annual competition for funding. For this reason the RIIO handbook⁸ sets out our intention to designate a new class of licence (an innovation licence) that is directly linked to the innovation stimulus package.

The innovation licence would:

- authorise the holder to receive monies under the scheme;
- provide Ofgem with powers necessary to ensure the scheme is effectively administered, including through monitoring and assessing results; and
- contain provisions for information to be provided to Ofgem on request.

The innovation licence would have no application to activities outside the scheme, including any other innovation projects the company or other parties may wish to pursue.

Options for third party access

Preliminary discussions with some third parties suggest that the regulatory burden associated with having to apply for an innovation licence might deter third parties from participating directly in the innovation stimulus competition. In responding to our October open letter several third parties favoured collaboration with network companies as a way of involving third parties, over giving them direct access to funding. We are therefore consulting in this letter on three options for third-party access to innovation stimulus funding, as follows.

- Option 1 – Third parties can compete on the same basis as network companies for project funding from the innovation stimulus through applying for an innovation licence.
- Option 2 – Third parties can apply for project funding from the innovation stimulus where the project is not carried out on a licensed network⁹ (i.e. it is an off-network project). This would involve applying for a more limited licence.

⁶ The Gas Act as currently drafted does not allow transfers of funds between Gas Transporters (GTs), preventing GTs from receiving innovation stimulus funding.

⁷ Creating an innovation licence requires a change to the Gas Act to designate a new class of licence. The Gas Act does not currently allow GTs to transfer funds to other GTs, but creating a new class of licence would allow a consequential amendment to the Act allowing GTs to transfer funds to holders of an innovation licence.

⁸ RIIO Handbook, available at

<http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/RIIO%20handbook.pdf>

⁹ Part of the Gas Transmission System, Gas Distribution System, Electricity Transmission System or Electricity Distribution System.

- Option 3 – Third parties can only access the innovation stimulus funding through collaboration with licensed networks operators. Third parties would not require any licence to participate in the innovation stimulus via a network-led collaboration.

Below we discuss each of these options in further detail. A summary of our initial thoughts on implications of each option is attached as an appendix to this letter.

Option 1 – Third parties compete on the same basis as network companies for project funding from the innovation stimulus

There are a number of advantages to allowing suitable third parties¹⁰ to compete directly against network companies for innovation stimulus funding. It could increase the range and types of projects submitted to the annual competition for innovation stimulus funding. Doing so may also enrich the learning that comes from innovation projects. Direct competition for funding between network companies and third parties could increase the quality of submissions.

Option 1 also has a number of disadvantages, some of which are significant. Third parties who want to carry out projects on the network could effectively be acting as a transmission distribution or transporter licensee and may therefore require the relevant network licence to avoid falling foul of the relevant prohibitions under the Acts. The regulatory burden of becoming a network licensee could act as a deterrent to third parties and the network licences would require amendment to facilitate this option.

In addition, if the innovation project proposed by a third party involves trialling on a licensed network the third party will need access to that network. We would expect third parties and network companies to work collaboratively, but arrangements would need to be in place should network companies fail to offer fair and reasonable terms of access. Such arrangements would also need to ensure network companies were not disadvantaged by innovation trials on their networks. For example, innovation trials might put network companies' security or reliability at risk or jeopardise their performance under various price control incentives.

Option 2 – Third parties can apply for project funding from the innovation stimulus where the project is not carried out on a licensed network.

Option 2 would give third parties direct access to the innovation stimulus funding only for off-network projects - those which have no on the operation of the network (e.g. research and development, analysis of operational data, modelling demand-side response, or tariff arrangements). Third parties wishing to undertake on-network projects would only be able to do so by partnering with a network company.

This approach has a number of advantages. Retaining third party access widens the scope of potential projects beyond just those which the network companies are either involved in or interested in sponsoring. As third party direct involvement is limited to off-network projects only, third parties would not need a network licence (only an innovation licence, along the lines envisaged in RIIO and noted above). Network companies would not be obligated to provide access to their network, removing the need for further network company obligations.

The main disadvantage to this option is that it could limit innovation on licensed networks, should network companies fail to support promising innovations which require access to the networks for trialling. In addition, good ideas from third parties could be part of a larger bid which is not of sufficient quality to win funding. We are proposing further network company

¹⁰ Non-network companies would have to demonstrate they are well placed to undertake innovation related to network services, including understanding of network operation, suitably qualified staff and experience, a fully worked up project proposal and ongoing dialogue the relevant network company. Further details are set out in the RIIO Handbook, p126, op cit.

obligations (see below) designed to promote collaboration which could mitigate these disadvantages.

Option 3 – Third parties can only access innovation the stimulus funding through collaboration with licensed networks operators

This option would give third parties indirect access to innovation stimulus funding only by partnering with network companies. This option mirrors the arrangements currently in place in the LCN Fund. Experience in the first year of the Fund suggests that collaboration between network companies and third parties can be successful and constructive. A wide range of third parties were involved in projects the electricity distributors submitted to the first year's competition. To-date we have received no complaints of network companies being unreceptive to the ideas of third parties.

However, under the collaborative approach, network companies could prevent third parties from accessing funding, should they wish to do so. For example, network companies could choose to collaborate on innovations at trial stage but not at earlier stages. The extent to which third parties wishing to collaborate in future would be prevented from doing so is unclear.

The innovation package set out in RIIO intended to stimulate innovation at all stages of the innovation cycle prior to rollout. Early-stage innovation by third parties may well not require network company involvement, but under this option there would be no route to innovation stimulus funding for such innovation projects.

Our initial view

At this stage option 2 appears to provide a good balance between providing third party access and imposing proportionate regulatory burden on both network companies and third parties. It widens the scope of third party access to innovation, while seeking to build on the success of collaboration so far.

Nonetheless, we recognise the risk that collaboration does not allow third parties sufficient direct access to funding. We recognise the potential benefits of option 1, and may consider implementing this option at a later date should we consider that option 2 is limiting innovation. **We welcome your views on these options.**

Encouraging collaboration

Under any of the options set out above, network companies could prevent third parties from gaining access to innovation stimulus funding. The impact of this would depend on which option we take on third party access. We believe that collaboration is the best approach for many innovation projects (though not all). Independently of which option we take of the above, we therefore propose to introduce obligations on network companies to encourage them to collaborate with third parties in their innovation stimulus submissions. These could include, for example, a forum for third parties to lodge ideas (such as that in place for the LCN Fund) or an appeals process to which third parties could take any grievances. These would be designed to give third parties every opportunity to collaborate with network companies.

Next steps

Based on responses to this consultation, we will consider whether the resource implications of creating a licence are proportionate, both for potential licence holders and for Ofgem in creating and maintaining the licence. If we proceed with the creation of an innovation licence, these arrangements need to be in place before 1 April 2013 for the next price control reviews. We would develop the licence over the course of 2011 in consultation with stakeholders.

The creation of a new class of licence¹¹ requires the Secretary of State to make an order. We have already begun early discussions with Department of Energy and Climate Change (DECC) on the range of proposals we are considering.

Views invited

Ofgem would like to hear the views of interested parties on the issues set out in this letter. We would especially welcome responses from non-network parties who may consider applying for funding under the innovation stimulus package in the future. Please submit your views on the following questions.

We invite your views on the options presented above. Which of these options do you prefer? Please give reasons for your preference. Do you have further ideas for encouraging collaboration?

We also invite you to put forward any alternative options which we have not presented in this letter.

We would welcome responses to this letter by **4 March 2011**. Unless clearly marked as confidential, responses will be published on our website. Please email responses to anna.rossington@ofgem.gov.uk.

Yours faithfully,



Rachel Fletcher
Partner, Distribution

¹¹ A gas and electricity 'innovation licence'.

Appendix – Implications of options 1 to 3.

	Option 1	Option 2	Option 3
Third party direct access to receiving innovation stimulus funding (by leading projects)	'On-network' and 'off-network' innovation	'Off-network' innovation only	No direct access for third parties, collaboration only
Potential strength of competition for innovation stimulus funding	Greater - wider range of parties potentially able to compete for funding	Wider range of parties potentially able to compete for funding – but only for 'off-network' innovation	Lower – only network companies able to directly compete for funding
Risk to network companies associated with third party-led projects carried out on their network	Potential risk from third party-led 'on-network' innovation, additional arrangements needed	None from third party-led projects. Collaboration mitigates risks for on-network projects	None from third party-led projects. Collaboration mitigates risks for on-network projects
Additional arrangements required to address safety / reliability /price control performance concerns associated with third-party led 'on-network' projects	Yes	No	No
Regulatory burden on third parties applying for and holding a licence	Yes, third parties licensed	Yes, third parties licensed	None