

Innovation Working Group

Notes and issues from first Innovation Working Group meeting held on Thursday 20 January 2011, at Ofgem's offices, 9 Millbank, London.

From	Melinda Anderson
To	Innovation Working Group
cc	
Date	17 February 2011

1. Introduction

The Innovation Working Group was established to gather stakeholder views on the RIIO innovation stimulus proposals, as set out in our [October 2010 open letter consultation](#) on the development of gas and electricity innovation stimuli. We envisage that the working group will meet approximately every 6 weeks during development of the innovation stimulus, with the meetings chaired by Ofgem. All material generated by the group will be published on the Ofgem website.

Anna Rossington (AR) welcomed attendees and outlined the purpose of the meeting - to obtain feedback from the working group on our [December 2010 consultation on innovation](#).

These notes attempt to capture the key points of discussion. They do not indicate or imply Ofgem's agreement to points made by attendees.

2. Innovation stimulus scope

AR began the meeting with a brief overview of the terms of reference for the working group. This was followed with a recap of the RIIO model and the innovation stimulus package. The group then moved on to discuss the scope of the innovation stimulus. Two questions were the focus of the discussion 1) should the innovation stimulus be targeted at low carbon projects or more widely (i.e. at projects which contribute to long term network sustainability) and 2) should the scope differ between gas and electricity?

The general view in relation to scope was that it should not be unnecessarily narrow. It was broadly accepted that low carbon should be the overarching goal, but also recognised that that multiple aims of innovation cannot be isolated. These wider aims could encompass sustainability, security of supply, affordability, wider innovation in commercial arrangements and technological innovation.

Broader aspects of the scope were discussed including the importance of keeping cross-boundary projects in scope. For example, this includes projects encompassing both gas and electricity network innovation as well as projects that cross geographical boundaries. AR asked whether barriers exist in terms of the split structure of the funding (i.e. the two 'pots' of funding – one for gas and the other for electricity) rather than the scope and whether this would prevent networks suggesting cross boundary projects. Issues were raised about the impact that the separation of funds between gas and electricity may have and whether this would deter proposals for cross boundary projects.

It was suggested that cross-boundary projects would work best based on a consortium basis where different partners could bid for separate components contingent on other partners receiving funding. AR responded that projects will be assessed on the basis of their overarching objectives and pointed out that the LCN Fund favoured projects with more collaboration. AG suggested testing how such a project could be controlled and offered to work up an example of a cross sectoral project.

Discussion on the respective scope for gas funding and electricity funding mainly focused on the gas scope. The main concern was uncertainty over the future of gas networks,

however the role of gas as a significant transition fuel was also discussed. Other key areas of gas network innovation such as using the gas network to transport other types of gas (such as biomethane for consumption or CO₂ for storage) were also discussed. In general it was accepted that it was difficult at this stage to say whether the scope for gas should be different than electricity where the opportunity for innovation is more readily identified. It was also commented that the gas scope should be wide enough to accommodate the level of uncertainty around the future of gas rather than being constrained because of it.

Concerns were raised about how we will compare bids for projects, for example distribution projects versus transmission projects. An example provided referred to the selection criterion that requires the information and knowledge gained from funded projects be shared. It was asked how would we compare a transmission project (which has no one to share information with) with a distribution project (which can share information with lots of network operators)?

The group discussed the tension between competition (competing for funds) and collaboration. For example will competing for funds reduce transmission and distribution operators' appetite for collaborating on projects which are seen as key to a low carbon future? Although the benefits of competition were recognised it was flagged that even with competition there is the potential for collaborative partnerships to become 'closed' and for companies to stop seeking new partners. The group agreed that we need to ensure that this does not happen.

Another concern raised was that expensive large scale projects may crowd out smaller projects or vice versa. Some attendees recommended a notional allocation between transmission and distribution.

Discretionary rewards were discussed. Concerns were raised about proposals to set the level of self funding at 20%. It was argued that if the level self funding was set at 20% this could be a very significant amount of money for very big projects and could deter companies from applying for funding.

Some group members felt that a discretionary fund would be required to incentivise companies to innovate via the innovation stimulus package if the level of self funding was set at this level. One view was that discretionary rewards can deter collaboration. Another group member queried whether it was the competitive aspect that was more of a deterrent to entering than the reward. AR responded by saying that these points will be consulted on in future policy papers and could be discussed further in future working group meetings.

3. Innovation stimulus funding amount and profile

The working group was asked whether they agree with Ofgem's proposed amounts of funding. In particular the group was asked if there are any further arguments for different funding levels which we have not considered. AR also asked whether the funding profile should remain constant over the price control period or reduce over the price control period?

The general consensus around funding was that it should have the right 'headroom' and sufficient flexibility regarding the amount spent each year. The group commented that for larger projects (especially in transmission) annual funding may be too frequent and a solution to this would be to apply for 2-3 years worth of funding every 2-3 years. Ofgem noted this view but stressed that the purpose of a specified maximum was to give certainty to network customers and suppliers on the total amount that can be levied in a given year.

The group queried how the gas/electricity split in funding was calculated, how we know it is correct and whether we should investigate further. The group was challenged to justify funding gas on the same scale as electricity. The group discussed the scope for gas innovation including reducing the carbon impact of shipping gas; changing demand

patterns as new technology is introduced and additional flow management issues related to multiple small entry points.

A question was raised as to whether the funding profile should reduce over time. An example was given that if large projects are funded first we may see a reduction in applications as companies are busy delivering. It was further suggested that funding could be reviewed at the end of the first four years of the price control period rather than at the end.

4. Innovation stimulus funding mechanism

AR asked the group for their views on how the costs of the innovation stimulus should be passed on to network companies' customers. The options of fast money, slow money and a share of fast and slow money was discussed.

It was broadly agreed that fast money was the preferred mechanism. Fast money was defined as money made available throughout the course of the project and passed through to customers immediately. Ofgem confirmed that funding under this option would be granted up front to competition winners – any 'slow money' element would be in the way network companies were allowed to treat the expenditure. It was also noted that EU innovation money is provided in this way.

It was commented that the type of funding mechanism chosen will have an impact on financeability of projects. One area of concern was that for some projects and some companies there may be a lag between project completion and project return which may deter smaller companies from applying for funding. AR allayed these concerns by explaining that any sharing between fast and slow money applies only to the way network companies are allowed to raise money, not to the transfer of funding, which would occur in advance any required spending.

5. Innovation allowance

In the December 2010 consultation on innovation we discussed implementing an innovation allowance, a limited, direct allocation of funding to each network operator. The allowance was described as a limited amount of innovation funding that would let network companies pass through a proportion of innovation spending to customers, where it met specific criteria set by Ofgem. In order to gain funding network companies would have to include an innovation strategy in their business plans and should include outputs related to the innovation strategy. Network companies would decide how to allocate their innovation allowance between projects at different stages of the innovation cycle. We would cap the innovation allowance to incentivise companies to utilise the allowance efficiently.

One participant warned against funding innovation for innovation sake but it was accepted that the IFI was considered a successful model and there were merits in retaining something similar. A question was raised about whether the innovation allowance would be restricted to low carbon as in the innovation stimulus or not restricted as in the IFI. AR responded that this had yet to be decided.

AR outlined the capping options that we sought views on in the December consultation - a fixed cap on innovation spending as % of allowed expenditure of producing a sufficient innovation strategy and a proposed a cap (by network companies) up to a maximum specified by Ofgem, justified by an outputs-based innovation strategy.

A question was raised that if the innovation stimulus percentages are different between gas and electricity should this follow through for projects agreed via revenue allowances? It was argued that some costs are the same for both gas and electricity (i.e. preparation costs).

Some participants commented that it would be difficult to create an innovation strategy to cover the eight year price control, They also commented that the outputs approach would

also be difficult because innovation outputs would be difficult to define and may extend beyond the 8 year period. It was also noted that any outputs approach must allow for the potential that a project may fail – otherwise it would risk companies being put off applying for funding.

On the issue of a cap, 1-2 % was deemed fair.

6. Revenue adjustment mechanism for rolling out innovation

AR led discussion about this proposal which would allow companies to come forward with proposals to roll out innovative techniques during the price control period. We are aware that new information could become available during the price control period to prove the case for further rollout of innovative ideas. Without some form of in-price control mechanism, there is a risk that companies will delay roll out of valuable projects that would benefit consumers until the next price control review (where they could include them in their business plans).

The group was asked whether they agreed with the proposal to include a revenue adjustment mechanism within the price control period; whether they agreed with our views on the criteria for such an adjustment and how frequently we should allow companies to apply for this adjustment.

The idea of allowing companies to apply within the price control period for additional funding was generally well received. One member highlighted that a revenue adjustment mechanism would not necessarily need to provide an actual adjustment within the price control period but could instead commit to an adjustment in the next price control. It was felt that this could help to increase the flow of innovative rollout.

A question was raised around how we would measure against the criteria. The group noted the potential for carbon savings to be used as a comparative measure between projects however one member highlighted the importance of considering the abatement cost relative to the carbon abatement costs of other policies in a wider context.

In terms of frequency it was generally agreed that annually was preferable however another option put forward was that of having a 'window' period for submitting readjustments. Some favoured this approach because of its less restrictive timetable but others noted that it could be administratively burdensome. In discussing the 'window' option an issue that not all companies would want/need to roll out an innovation at the same time. Another issue that was raised was the fact that for new technologies, the unit cost will usually reduce significantly as more are rolled out. Therefore the first company to apply for a re-opener could gain (where they are rolling out over several years) if the re-opener is based on the costs at that time – and unit costs subsequently drop as others roll it out..

7. Third party access to innovation stimulus funding

The group discussed our initial views on the third party access to innovation stimulus funding, as set out in our [January 2011 open letter consultation](#).

AR introduced the three options currently being consulted on in relation to third party access to innovation stimulus funding – Option 1, third parties compete on the same basis as network companies for project funding; Option 2, third parties can only access funds through collaboration with licensed network operators; Option 3, third parties can only apply for funding for projects which are not based on a licensed network.

The group asked why Ofgem thought that third party access to innovation stimulus funding was necessary. Debate focused on the risk-averse nature of network companies. It was felt

that creating opportunities for third-party involvement in network innovation would encourage more innovation and collaboration.

It was recognised that network companies may be averse to providing direct access to third parties to their networks for good reasons – since the third party could impact negatively on networks meeting their regulatory and legal obligations. There was some consensus among network representatives that network companies would be unlikely to say no to a worthwhile project and so providing direct access to funding for third parties was unnecessary. However it was strongly argued by third party representatives that an environment should be created to allow for the most innovation as possible rather than let DNOs be the sole gatekeeper.

Another view was that it is difficult to predict where innovation in the future will come from and therefore we need to 'leave the door open'. If third party projects are confined to Research & Development (R&D) and lab work (i.e. off-network projects) it was suggested that Option 3 would be best. Although one view was that Intellectual Property Rights (IPR) issues may deter third parties from applying for R&D funding through this route. This was considered more of an issue in relation to commercial companies but it was also questioned whether commercial companies should be funding innovation themselves.

One view was that under Option 1 there is a danger that Ofgem becomes the 'procurer' of all innovation.

8. Further issues going forward

The group was asked what it would like to discuss in the next working group meeting. It was agreed that further discussion around funding would be beneficial, in particular, the scope of funding and the criteria for awarding funding.

Additionally it was agreed that more discussion is needed about how projects are funded. This was particularly focussed on whether a project should be funded over the first year (as with the LCN Fund projects) or over the life of the project.

Discretionary rewards were also deemed worthy of a revisit, particularly in light of the proposal that the self funding element of the stimulus be increased from 10-20%.

9. Close

AR summarised the key points of discussion and thanked attendees for their participation. The next meeting was tentatively scheduled for 2 March 2011.

10. Appendix

Iain	Welch	National Grid Transmission
Martin	Hill	SP Transmission
David	MacLeman	SSE Transmission
Richard	Buckley	Scotia Gas
Nigel	Winnan	Wales and West Utilities
Gareth	Mills	Northern Gas Networks
Gaynor	Jones	National Grid Gas
John	Christie	DECC
Alasdair	Granger	DECC
Craig	Dennett	Combined Heat and Power Association
Alex	Murley	Renewable UK
Jason	Eis	The Carbon Trust
Taco	de Vries	Intellect representative
Stephen	Benians	The Regulatory Assistance Project

Christine	McGourty	The Energy Retail Association
Dave	Openshaw	DNO representative