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Dear Anna

**Impact of the Interruptions Incentive Scheme (IIS) on Second Tier Low Carbon Network (LCN) Fund Projects**

We agree that it is important to strike a balance between incentivising companies to bring forward innovation projects that have long term benefits for customers whilst continuing to provide an incentive on companies to minimise the impact of supply interruptions on customers.

As previously stated, we believe that planned and unplanned supply interruptions incurred under First and Second Tier LCN funded Projects should receive protection from IIS penalties. The proposals within this consultation only outline proposals for supply interruptions associated with Second Tier projects. All three options extend the administrative burden on DNOs and options 2 and 3 appear to increase the uncertainty for full protection offered against Second Tier LCN funded Projects, when compared against the statutory consultation in November 2010.

Our preferred approach for planned interruptions is option 1. We propose the IIS penalty incurred from planned interruptions (for installation of equipment and where applicable its decommissioning) associated with an LCN funded project is covered by an award at the start of the project. This will provide companies with an ongoing incentive to minimise the impact on customers whilst removing the disincentive to bring forward projects. As DUoS charges are charged to suppliers and may not be passed onto customers part of an LCN funded trial, other mechanisms should be explored for rewarding individual customers for participating in an LCN funded project. We will support the introduction of the new inputs required in the application for potential Second Tier LCN funded Projects under the mini-review of the lesson learnt from the 2010/11 Second Tier LCN Fund process.

This arrangement for planned interruptions within Second Tier projects must be supplemented with arrangements for First Tier projects and for unplanned interruptions. Without these additional arrangements companies may be discouraged from bringing forward innovative projects that incur higher than normal risks of supply interruptions. For planned interruptions associated with First Tier projects we recommend that companies should be allowed, in a similar way to Second Tier projects, to include the forecast IIS impact when they register the project and utilise a portion of the First Tier pot as compensation for anticipated IIS penalties.

For unplanned interruptions we believe that two approaches should be employed depending on the nature of the project. For LCN funded projects that trial new commercial arrangements and/or technologies that are expected to result in contractually permissible interruptions (eg with interruptible tariffs) the unplanned interruptions associated with the projects should be exempt from the IIS scheme. For all other LCN funded projects (both First and Second Tier) we recommend that a new class of exceptional event be created within CRC8 to adjust incentive performance for material interruptions resulting from mal-operation of assets installed under LCN funded projects. We believe that the materiality threshold for this exception should be a value commensurate with the loss of a primary substation. In this way DNOs are protected from material risks but retain an incentive both to avoid a major interruption (because they are exposed to impact up to the threshold) and to manage the impact of any event (because to do otherwise might result in their exceptionality claim being refused).

I have responded to the consultation questions and my responses are included in the Appendix 1 attached to this letter. I hope you find the comments useful and if you have any questions or queries please do not hesitate to contact me.

Yours sincerely,

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Head of Economic Regulation

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## Appendix 1 Responses to Consultation Questions

Please find below specific responses to the questions raised in your consultation.

### **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.**

The Low Carbon Networks Fund scheme offers the opportunity for distribution network operators (DNOs) to trial new equipment and/ or new operating and commercial arrangements in order to develop the necessary technical and commercial solutions for the flight path to the low carbon economy. It seems perverse to dampen the enthusiasm of DNOs to participate in the scheme because the current IIS incentive mechanism would penalise a DNO for undertaking a LCN funded project.

LCN funded projects will either involve:

- the trialing (and/or development) of new equipment on the distribution network or the installation of existing equipment onto the distribution network, although applied in new novel ways; and/ or
- the trialing of new commercial and operating arrangements, for example interruptible connection contracts.

The former type of project will require planned interruptions to install the equipment whilst the latter type, could result in the supply interruptions which although unplanned in nature would have been agreed contractually with the customer(s). Both will inherently increase the risk of unplanned supply interruptions over the duration of the project. Therefore it is appropriate not to apply an incentive mechanism that discourages DNOs from participating in the LCN Fund scheme, due to the potential penalties that could be incurred from both planned and unplanned interruptions. We believe that this principle applies equally to First and Second Tier LCNF projects. Ofgem's assertion that First Tier projects are unlikely to be large enough to incur significant IIS penalties lacks evidence and is contrary to a sample of the recently registered First Tier projects as some of these projects are at the million pound level and above (eg EFT1002 and WPDT1002). Protection should be applied to equally First and Second Tier LCN funded projects and cover both planned and unplanned interruptions.

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

It is appropriate for GB customers to fund the IIS penalties for LCN funded projects as they will share from the learning generated. Learning will be generated by all LCN funded projects, whether classified by the Expert Panel and Ofgem as successful or not. In some instances unsuccessful projects can also provide customer benefits as much as "successful LCN Funded projects can provide considerable customer benefits".

In providing protection to DNOs from supply interruption penalties we welcome the proposed measures by Ofgem to balance the interests of customers. We support Ofgem's proposed approach to include additional information on potential supply interruptions in the Full

Submission application as this provides a balancing mechanism in the evaluation and approval processes for Second Tier projects. If accepted, on completion of this consultation, these proposals should be included within the mini-review of the lessons learnt from the 2010/11 process and the LCN Fund Governance Document v.3 and the First and Second Tier application forms updated accordingly.

It is not possible to guarantee that customers participating in an LCN funded trial receive lower DUoS charges as DUoS charges are levied on suppliers and marginally lower DUoS charges may not be reflected in lower supplier charges, for a number of reasons. For example, in WPD's Low Voltage Network Templates project WPD's income may potentially reduce by £1.6m due to supply interruption penalties which equates to less than 1% of allowed revenue resulting in a drop of several pence per customer. This reduction in DUoS will be applied across the whole of WPD's South Wales customer base whilst the LCN funded trial involves only 10% of its population. An alternative mechanism should be explored which rewards customers for participating with an LCN funded project.

Below I have made specific comments on each of the options being considered, but further clarity is required on the application of all three options for the options to be fully evaluated:

**Option 1** This option provides full protection to a DNO for supply interruptions with the IIS penalties included within the LCN funded project, but it encourages pessimistic forecasting of supply interruptions so that a DNO is not financially disadvantaged during the LCN funded project. Administratively this option is burdensome as truing up is necessary at the end of the project to recover LCN funds from a DNO.

**Option 2** This option may not provide full protection to a DNO for supply interruptions as Ofgem is expected to review and deem whether supply interruptions have been justifiably incurred, after the event, and then the Ofgem will consider a discretionary reward application for successful projects only. It therefore appears there is more uncertainty for funding of IIS penalties with this option. In addition, a DNO incurs the penalties throughout the LCN funded project and may or may not receive the IIS penalty sometime after the close down of the project, which has an impact on the timing and potentially the size of cash flows, if not inflated. Again this option is administratively burdensome as truing up is necessary after the close down of the project to recover LCN funds from the discretionary reward mechanism.

**Option 3** Like option 1 this proposal will provide full protection to a DNO for supply interruptions, but could put at risk a DNO's Compulsory Contribution. Potentially a DNO could be securing full protection from a small IIS penalty whilst placing a much higher valued DNO Compulsory Contribution at risk. This would have been the case for our Corridor Manchester Smart City Project where the forecast planned interruptions were valued at £200,000 and the DNO Compulsory Contribution was £1.04 million.

Our preferred approach is option 1 for planned interruptions and an IIS exemption for unplanned interruptions. We propose the IIS penalty incurred from:

- planned interruptions (for installation of equipment and where applicable its decommissioning) within an LCN funded project is covered by an award at the start of the LCN funded Project;
- unplanned interruptions from failure of equipment (and potentially the early decommissioning of suspect equipment) within an LCN funded project are exempt (above a threshold) from the IIS scheme by creating a new class of exceptional event; and
- unplanned interruptions associated with contractually permissible interruptions within an LCN funded project are exempted by application of new input definitions with the penalty values set to zero.

As the current process is unable to identify and reward customers for participating in an LCN funded trial other mechanisms should be explored

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

Option A is the simplest least burdensome mechanism for covering the costs of the IIS penalties incurred from supply interruptions for the 2010/11 LCN funded Second Tier Projects. Option B would require amending CRC8 specifically for projects to be delivered under the 2010/11 Second Tier process.