



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

Promoting choice and value for all gas and electricity customers

Direct Dial: 020 7901 7194
Email: Rachel.Fletcher@ofgem.gov.uk

Date: 2 March 2011

Dear Colleague,

Decision on the impact of the Interruptions Incentive Scheme (IIS) on Second Tier Low Carbon Network (LCN) Fund projects

On 20 December 2010 we published a consultation inviting views on whether second tier LCN Fund projects should be protected from IIS penalties¹. Under the IIS, Distribution Network Operators (DNOs) are encouraged to deliver a good quality of service and reduce the number, duration and impact of supply interruptions. The LCN Fund provides funding for DNOs to undertake innovation trials on their networks – some of which may involve interrupting customers' supply.

This letter sets out our decision that LCN Fund projects should be protected from penalties associated with planned interruptions. If DNOs require such protection they will need to include the anticipated cost of any penalties in their request for second tier funding. We have also decided that current LCN Fund projects which involve customer interruptions will be provided protection from IIS penalties through the discretionary funding mechanism.

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 the price customers pay reflects the quality of service they receive from their DNO.

The LCN Fund

We created the LCN Fund in recognition that 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.

The LCN Fund is designed to encourage the DNOs to try out new technologies, operating practices and commercial arrangements which have the potential to facilitate these changes. A key feature is that learning gained from projects must be shared with all other

¹ <http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/IIS%20consultation%20letter.pdf>

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.

Projects are funded through two funding mechanisms. 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.

Decision

In our December consultation we invited views on three specific questions. We received responses from all DNOs and also from a technology manufacturer. A summary of responses is included in appendix 1 to this letter. We set out our decision, and reasoning, on each specific issue below.

Should second tier LCN Fund projects be protected from IIS penalties and should this protection apply to all interruptions or only planned interruptions?

In our consultation we recognised that the IIS plays an important role in protecting the interests of customers by incentivising DNOs to maintain a high quality of service. However, we also noted that the LCN Fund can also provide considerable benefits to customers through providing knowledge and learning to design and operate the networks which are required as Great Britain (GB) moves towards a low carbon economy. We considered that IIS penalties could stifle the innovation and consequent learning which LCN Fund projects are able to produce.

All respondents agreed that without at least some degree of protection for second tier LCN Fund projects against IIS penalties, DNOs may be discouraged from proposing beneficial projects that might entail interruptions. We note that there was widespread support amongst DNOs for this protection to apply to unplanned, as well as planned interruptions, with one DNO commenting that it should only apply to planned. We note that one DNO did not support unconstrained protection against IIS penalties on the basis that DNOs will be less inclined to consider, and take, all reasonable steps to keep interruptions to an absolute minimum.

We have decided that second tier LCN Fund projects should be protected from IIS penalties but recognise the need to maintain incentives to minimise the interruptions associated with these projects. Therefore, we consider that the expert panel² 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 planned 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.

Any protection will be 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 of the interruptions to their service and how their needs will be handled (including how vulnerable customers will be treated).

² 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.

An important principle is that the DNO will 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. We do not agree with those respondents who stated that the protection should also apply to unplanned interruptions. We consider that by providing protection for unplanned interruptions, we would remove the requirement to identify the level of interruptions upfront. Consequently, neither the expert panel nor the Authority would be able to assess the size of the impact on customers when evaluating the project. Unplanned interruptions are a project risk, like any other, which the DNO has to manage. We want to ensure that the DNO is still incentivised to operate its business to normal business standards where a second tier LCN Fund project is being deployed. Providing protection for unplanned interruptions would remove this incentive. We consider that only protecting planned interruptions strikes an appropriate balance between encouraging innovation whilst maintaining the incentives on DNOs to continue to deliver a high quality of service to customers.

We note that one DNO commented that protection against IIS penalties should also be provided for first tier projects. We acknowledge that first tier projects could, potentially, involve customer interruptions. However, we are keen to maintain a balance between encouraging innovation and protecting customers. Second tier projects are subject to a significantly higher degree of evaluation than first tier projects. This allows the expert panel to consider the levels of interruptions against the potential value of the project for customers. This oversight is not in place for first tier projects and therefore, we do not consider that protection against IIS penalties is appropriate. Further, we note that a number of existing voluntary schemes, such as the undergrounding of lines in areas of outstanding natural beauty or projects to improve service to worst served customers are not provided protection from IIS penalties.

Which is the best way to implement protection for second tier LCN Fund projects from IIS penalties (if appropriate)?

In our December consultation we set out three ways in which protection could be provided for future LCN Fund projects. These were either through including an estimate of the IIS penalty in the project funding request (option 1), funding the penalties through the discretionary reward funding mechanism once the project had concluded (option 2), or amending the licence³ so as to exempt LCN Fund projects from incurring IIS penalties (option 3).

As outlined in appendix 1, respondents' views were largely split on this issue. We outlined in our December consultation that we preferred an approach which maintained the relationship between customers' charges and the quality of service they receive from their DNOs. We noted that options 1 and 2 maintained this relationship. We were, and remain concerned that option 3 does not. Whilst this option received some support amongst respondents, we note that they were unable to present a case as to how the relationship between customers' charges and quality of service would be maintained under this option. We have outlined above how LCN Fund projects can benefit all GB customers. Consequently, we consider that if some customers experience the inconvenience of interruptions in order to achieve these benefits, then all GB customers should fund the penalties which reflect the lower quality of service received by those customers where the project takes place⁴.

Of the two remaining options, we note that there was more support amongst respondents for option 1. We agree and consider that this represents a more transparent way of implementing protection against IIS penalties for LCN Fund projects. It enables the Expert

³ This would involve a change to charge restriction condition (CRC) 8 of the electricity distribution licence.

⁴ Under the IIS mechanism, if a DNO falls below a target level of customer interruptions, then they are penalised through a reduction in the allowed revenue they can recover from their customers. Consequently, all customers in that DNO area, including those who experienced the interruptions, will receive marginally lower distribution use of system charges.

Panel and the Authority to evaluate any interruptions as part of the project cost. We consider that this will incentivise DNOs to minimise the level of interruptions associated with their project. Further, since protection will only be guaranteed for the level of penalties included in the funding amount, it provides DNOs with a strong incentive to keep within this level when undertaking their project. We note that two respondents proposed a hybrid approach which merged two of the options presented. These hybrids were designed to maximise the incentives on DNOs to minimise the level of interruptions. We do not think such hybrids are required since these incentives will be delivered through the upfront evaluation of the level of interruptions the DNO is requesting protection from and the fact that a DNO will only be protected from the approved level of interruptions.

We do not consider that the use of the discretionary reward (option 2) would provide this level of transparency or enable a direct evaluation between those projects with and without interruptions. Notwithstanding the ability to place obligations on DNOs within their successful delivery reward criteria to stay within a certain level of interruptions, we consider that option 1 places much stronger, up front, incentives on DNO to minimise the level of interruptions. We have therefore decided that DNOs will include the cost of any IIS penalties within their second tier project submissions.

Which is the best way to implement protection for current LCN Fund projects which involve customer interruptions?

The third issue on which we invited views in our December consultation was how current LCN Fund projects could be protected against IIS penalties. Two projects selected for funding from the LCN Fund in November 2010 involve customer interruptions – Low Carbon London (UK Power Networks) and LV Network Templates (Western Power Distribution - WPD). In our consultation we recognised that we could not implement option 1 for these projects since the cost of the IIS penalties had not been included as part of the original funding requests.

Therefore, we set out 2 options to provide protection for the current projects; refund the cost of IIS penalties from the discretionary reward funding mechanism (option A) or a temporary licence amendment to exempt the two LCN Fund projects from incurring IIS penalties (option B). As stated above, we are keen to maintain the relationship between customers' charges and the quality of service they receive, as facilitated by option A. We were concerned that DNOs may not support option A since it would represent a change to the governance arrangements under which they submitted their project proposals. However, five out of the seven DNO groups supported this option. The remaining two DNOs considered option B to be less burdensome. We do not agree with this assertion and would highlight that implementing this option would require us to produce a new statutory consultation for the two DNOs concerned in order to introduce the temporary measure.

Consequently, we have decided to adopt option A in order to afford protection for those current projects which require customer interruptions. This decision will reduce the funding which is available under the discretionary reward funding mechanism up to a maximum of £1.724million⁵. We will set the precise value which we are funding once the projects have concluded and we are able to assess the reasonableness of the interruptions incurred.

Way forward

We have included the enduring solution in the new version of the LCN Fund Governance Document (v.4) which we have issued for consultation today.

We will be writing to the two DNOs with existing projects requiring IIS protection to set out our decision for current projects. We will seek amendments to their project directions to include a target level of interruptions in their successful delivery reward criteria. As part of

⁵ WPD have outlined that the penalties resulting from their anticipated level of interruptions are likely to be £1.6million. UK Power Networks have outlined anticipated penalties of £124,000.

the project ex post assessment we will only fund those penalties associated with a level of interruptions which we deem reasonable, given the work being carried out. This will place an incentive on the DNOs concerned to minimise the level of interruptions associated with their project.

It should be noted that we have required all winning projects from the LCN Fund first round to submit a customer engagement plan (including how the company will communicate and manage interruptions) for Ofgem's approval in advance of initiating any work with customers.

If you have any questions in relation to this decision please contact Mark Askew at mark.askew@ofgem.gov.uk or on 0207 901 7022.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is positioned above the typed name.

Rachel Fletcher
Partner, Distribution
For and on behalf of the Authority

Appendix 1 – Summary of responses

Appendix 1: Summary of responses

All DNOs responded to this consultation along with one equipment manufacturer. The responses to each of the questions posed are summarised below.

Should Second Tier LCN Fund Projects receive protection from IIS penalties?

All respondents commented that it was appropriate to lend some degree of protection to second tier LCN Fund projects against IIS penalties. Scottish & Southern Power Distribution (SSE) proposed that only planned interruptions over the anticipated level outlined in the project submission should be afforded protection. Central Networks (CN) commented that protection should be given for planned interruptions. All other respondents felt that planned and unplanned interruptions should be protected. Electricity North West (ENW) considered that first tier LCN Fund projects should also be provided protection from the IIS.

Which is the best way to implement protection for second tier LCN Fund projects from IIS penalties (if appropriate)?

ENW, Finmeccanica and WPD supported Option 1 on the basis that the expert panel and Ofgem would be able to assess the levels of interruptions expected at the evaluation stage. WPD argue that this option would clearly illustrate the economic cost of interruptions to customers. They add that customers in a trial area will pay slightly lower bills as a result of interruptions if this option is adopted.

Central Electric UK (CE) and UK Power Networks (UKPN) supported Option 2. CE commented that this option would strike the best balance between protecting companies from IIS penalties whilst ensuring that they used the most efficient method available to minimise interruptions. CN supported Option 3 on the basis that it would incentivise the companies to keep planned interruptions at or below the level they predicted in their project submissions.

Two DNOs, Scottish Power Energy Networks (SP) and SSE, preferred hybrid options of the options set out in the consultation. SSE preferred a combination of Options 1 and 2 arguing companies would be asked to set out their planned interruptions in their project plans. Over the course of the project DNOs would log up the cost of any IIS penalties. At the end of the project where companies can prove they minimised interruptions would be recompensed. SP would prefer a combination of Options 1 and 3, asserting that companies could set out an anticipated level of expense in their project proposals. They proposed an exemption up to this level with DNOs being liable to any penalties associated with interruptions which exceeded this level.

Which is the best way to implement protection for current second tier LCN Fund projects which involve customer interruptions?

CE, SSE, ENW and UKPN supported Option A. CE argued that Option A would provide the best compromise between protecting customers whilst minimising administration. UKPN also felt this was the most efficient means of protecting projects. SSE felt that the existing projects should be recompensed ex post should an increase in IIS penalties be identified as having been caused by the implementation of LCN Fund projects.

CN and WPD supported Option B as the least burdensome means of protecting DNOs from IIS penalties.