



Electricity distribution network operators (DNOs), independent distribution network operators (IDNOs), distributed generators, electricity 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

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Dear Colleague,

Low Carbon Networks (LCN) Fund lessons learned and second year process

In November 2010, we announced the four projects which had been selected for funding in the first annual competition the LCN Fund¹. We have now undertaken a brief review of the first year of operations of the LCN Fund with the aim of improving the process for future years. It should be noted that this was a high level review designed to improve the process and not a review of the policy around the LCN Fund. We plan to undertake a more comprehensive review following the conclusion of the second annual competition. Our review was informed through consultation with DNOs, third party project partners, the expert panel², consultants recruited to aid the evaluation process and the Department of Energy and Climate Change (DECC). We have also undertaken our own internal review of the process followed.

The purpose of this letter is to provide an overview of the feedback we received. This feedback highlighted a number of achievements alongside areas of good practice we would like to build on but also some areas which could be improved. We have, today, published a new version of the LCN Fund Governance Document (version 4) to reflect some of these areas. This will govern the arrangements for the second annual competition of the LCN Fund. This competition will commence in late April with DNOs submitting short form project proposals for initial screening. Full project proposals will be submitted in August with Ofgem announcing its decision on the selected projects in November. The detailed timeline for the second year process is set out in appendix 1 to this letter.

Background

We estimate that over £200 billion needs to be spent in the next 10 years to secure supplies for consumers and to move to a low carbon economy. Of this, over £30 billion will need to be spent on pipes and wires. Network companies will need to innovate in the way they design, build and operate their networks to meet the changing requirements of generators and consumers at value for money as we move to a low carbon economy. As part of DPCR5 we created the £500m LCN Fund to encourage the DNOs to use the current price control period (1 April 2010 to 31 March 2015) to try out new technologies, operating practices and commercial arrangements which are required to meet these challenges. More broadly and more ambitiously, the fund is intended to help the DNOs understand what role they should play in the overall supply chain in a low carbon energy sector. As such, the

¹ http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/LCNFunddecision_Final.pdf

² The Expert Panel were recruited by Ofgem to evaluate project proposals and make a recommendation to the Authority on which projects should be funded. More details can be found at: <http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/stlcnf/ExpertPanel/Pages/ExpertPanel.aspx>

learning is important not just for network companies but for the energy industry and its stakeholders as a whole.

The LCN Fund consists of two funding tiers. DNOs are able to use first tier funds (totalling £80m over 5 years across all DNOs) to recover a proportion of expenditure incurred on small scale projects. They can also use this funding to recover the expenditure incurred to put in place the people, resources and processes to progress larger innovative projects developed under the second tier. Under the second tier of the LCN Fund, Ofgem holds an annual competition to enable a small number of significant scale projects to receive funding. DNOs compete against each other for an allocation of the £64m funding available each year. This open letter focuses on the second tier of the fund.

As part of the new RIIO framework for network regulation, we are establishing the innovation stimulus³ which will build upon the LCN Fund principles and encourage innovation in electricity transmission and gas networks.

Review conclusions

Achievements

The LCN Fund has been widely recognised as stimulating much needed innovation in regulated companies. The concept has been internationally recognised as incentivising innovation which would not occur under the former RPI-X regulatory regime⁴. The detailed design has also been complemented for its focus and emphasis on specific learning outputs. These concepts are now being expanded to cover all network sectors under the Innovation Stimulus being developed as part of RIIO T1 and GD1 price controls. We will incorporate the lessons learned so far on the LCN Fund in the design of the Innovation Stimulus for transmission and gas distribution.

There was an excellent response from DNOs to the call for project proposals with at least one submission from each DNO group. There were eleven submissions in total with a combined funding request of £153m, vying for an allocation of the annual £64m funding available. Third parties have shown considerable interest and there was a broad range of collaborators heavily involved with DNOs in developing project proposals. The four projects which we selected for funding have been well received and were described by one analyst as some of the most interesting being undertaken in Europe⁵.

Areas of good practice

Clear, transparent and robust process

DNOs commented that they felt well consulted throughout the process of developing the design of the LCN Fund. The continuation of the environmental working group (EWG) meetings following the end of DPCR5 provided a good link between the price control policy and the development of the detailed governance of the fund. DNOs welcomed the staggered approach to the production of the governance document which enabled them to focus on one key stage at a time. They commented that they had good sight of the policy proposals which provided the confidence to develop project proposals.

We plan to continue to work alongside DNOs during the second year process. We sought DNOs' input to the detailed drafting of the revised LCN Fund governance document (v.4). We also plan to reconvene the EWG to discuss the project pro-forma which will be used to submit this year's project proposals.

³ <http://www.ofgem.gov.uk/Networks/Policy/Documents1/Innovation%20Stimuli%20%2012102010%20Open%20Letterpdf.pdf>

⁴ We have been invited to speak to European counterparts on the establishment of the fund and have received numerous comments pointing to the LCN Fund as a model which could be more widely adopted.

⁵ This quote came from a Bloomberg analyst report.

Strong project design and management

We invested significant time at the start of the project designing a workable plan to achieve the project deliverables. These deliverables included the publishing of 5 consultations and conducting 2 evaluation processes within the calendar year. Regular project management meetings and support from the project management group contributed to meeting the tight deadlines. We will continue to utilise Ofgem's project management group to input into the second round of project submissions.

Close liaison with different teams throughout Ofgem – Offshore Transmission and Environmental Programmes - helped to provide a broad range of input including lessons learnt from their experiences of similar projects. We will continue to work alongside these groups, particularly on the future design of the submission documentation.

Recruitment of independent expert panel

An open recruitment process led to the selection of a strong expert panel with a broad range of expertise and perspectives through which to evaluate the project proposals. The presence of the Chairman of the expert panel⁶ at the internal Ofgem Steering Committee meetings held during the development of the fund provided a strong continuity between the intent behind the governance and its implementation when evaluating the project proposals.

Use of independent consultants

The recruitment of consultants provided strong technical support to the expert panel throughout the evaluation process. The consultants were able to evaluate the detailed technical aspects of a project, summarise them and let the expert panel explore these further with the DNOs. The consultants also provided valuable assistance to the LCN Fund project team throughout the evaluation process. We will continue to use technical consultants in this way in future years.

Improvements to be incorporated into future years' process

Our review sought to identify specific areas where the process could be further improved and made to run more smoothly for future years. We have looked to incorporate these improvements into the new version of the LCN Fund governance document (v.4) which we have issued for consultation, alongside this open letter.

Ensuring that the fund continues to provide value

We plan to take a number of steps to ensure that the projects which are funded contribute to answering the key questions the DNOs and others need to address as they develop their business plans for the next 10 to 15 years. For the second year, we plan to make changes to the pro-forma in which DNOs submit their project submissions. These changes will ask DNOs to identify upfront the specific questions which their project seeks to answer. It will also invite DNOs to explain why these questions are important in helping them understand what they must do in the transition to the low carbon economy. Furthermore, we will ask DNOs to set out the specific learning outcomes they hope to achieve and invite them to outline how these will impact their business. We will ask them to present a case as to why the learning is additional from that which is likely to emerge from projects already selected for funding.

Adequately capturing the customer impact of project proposals

The first year process would have been smoother if we had required DNOs to provide more information in their submission around how their project impacted customers. For next year

⁶ The Chair of the Expert Panel is Dr. Robin Bidwell.

we will require DNOs to outline how their project will impact customers. This will also ask companies to submit their strategy for communicating this impact to the customers who will be affected. This will be evaluated as part of the project submission and where the strategy is not satisfactory it will reduce the likelihood of that project receiving funding.

In December we issued a consultation on the impact of the Quality of Service interruptions incentive scheme (IIS) on LCN Fund projects⁷. Following this consultation, we have concluded that where a project involves interruptions to customers' supply, companies continue to pay the incentive penalties associated with these interruptions⁸. So as not to deter innovation, we will ask DNOs to include the anticipated cost of any IIS penalties into their project funding request. This will enable the expert panel and Ofgem to explicitly evaluate the penalties as part of the project costs. This places strong incentives on DNOs to minimise the level of interruptions associated with a project and keep within that anticipated level when undertaking the project. The guaranteed standards⁹ put in place in DPCR5 will continue to apply for LCN Fund projects so that customers experiencing outages as a result of a LCN Fund project will receive compensation.

Design of the cost benefit analysis

The analysis provided by each company made very different assumptions about the low carbon future and consequently the combined net benefits presented for projects (of similar size and scope) varied dramatically. This meant that the expert panel and the Authority focussed on the qualitative account of the benefits projects which companies provided more than the quantitative.

Consequently, we have made some changes to the evaluation criteria in order to improve the basis on which the cost benefit analysis is provided. We have made a clear distinction between the carbon benefits and financial benefits in order to remove the scope for double counting within the two categories. We will require DNOs to compare both carbon and financial benefits to a base case of what would happen if the project did not take place. This will provide a better understanding of the marginal benefit of the project. We have provided specific new guidance on the qualitative case DNOs must present to outline their carbon benefits. However, for this year's competition at least, we have removed the requirement on DNOs to quantify the value of the carbon savings their project can achieve. This is in recognition that without detailed guidance, such quantification is subjective and of limited use in evaluating between proposals.

Interaction with the expert panel

The expert panel were generally pleased with the format of the bilateral meetings held between themselves and the DNOs. They considered they provided a good basis to explore questions they had on the project proposals. However, we recognise some of the DNOs' concerns that it would have been beneficial to have had more time with the expert panel to explain their projects.

We will look to establish some time earlier in the evaluation process where DNOs can meet with the expert panel and provide an overview of their project. This will also aid the expert panel who commented that they initially found it difficult to discern the essence of the project proposals from the submitted documentation. These meetings will be held prior to the bilateral meetings held later in the evaluation process.

⁷ <http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/IIS%20consultation%20letter.pdf>

⁸ Under the Quality of Service incentive scheme, DNOs are rewarded or penalised according to their performance against pre-agreed standards. These standards include the number and duration of customer interruptions. Where DNOs fall below these standards, they are financially penalised through a reduction in the allowed revenue they can recover from customers. Consequently, all customers in the DNO area receive marginally lower distribution charges to reflect the lower quality of service they have received.

⁹ Under the Guaranteed Standards of Performance for DNOs, customers can receive compensation if they are without supply for 18 hours or more (£54 for domestic customers). Customers can also receive compensation if they endure 4 or more interruptions throughout the year, each of which is 3 hours or more in duration (£54 for domestic customers).

Role of technical consultants

The technical consultants added real value to the evaluation process through their scrutiny of the detailed project proposals. Feedback from both the consultants and DNOs commented how both parties would benefit from the opportunity to meet and discuss the project proposals. We are looking to incorporate such a meeting into the evaluation process for next year. We consider that this will provide DNOs with an opportunity to explain the technical detail of their project.

Feedback not to be incorporated into future years' process

A number of parties have suggested that we should front load the profile of tier 2 funding so that more projects can start earlier in the DPCR5 period. We were clear in DPCR5 Final Proposals that there would be an annual competition for £64m. We therefore consider that this is a significant issue which is best dealt with in the larger review planned at the end of the second year's process, if there are still concerns that good quality projects are not able to receive funding early in the DPCR5 period.

Looking forward

We will be working with DNOs to establish a reporting framework to monitor the current LCN Fund projects. In appendix 1 we set out a high level timeline for the second year of the fund including dates for initial screening and full submission proposals. This will commence with the submission of short form project summaries for initial screening in April. This will determine the eligibility of the projects to compete for an allocation of the annual funding available.

We plan to undertake a more comprehensive review of the fund once it has been in operation for two years. This will seek to evaluate how the key policy design, as opposed to process, has worked. We will use some of the feedback received as part of this process to inform that review.

Separately, we have announced that alongside DECC we will establish a smart grid forum. This will seek to investigate any barriers to the development of smart grids and understand what Ofgem and DECC can do to address smart grid issues and aid efficient deployment.

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

Yours faithfully,



Rachel Fletcher,
Partner, Distribution

Appendix 1: Key dates for second year of LCN Fund

LCN Fund lessons learned open letter published	2 March 2011
Consultation on LCN Fund Governance Document v.4	2 March 2011
Closing date for consultation on LCN Fund governance document v.4	30 March 2011
Publishing of LCN Fund governance document v.4	1 April 2011
Second Tier Initial screening submission deadline	20 April 2011
Decisions on initial screening proposals	24 May 2011
Second Tier Full submission deadline	18 August 2011
Decision on Second Tier project funding	by 30 November 2011