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Your ref

Our Ref

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Contact / Extension

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Dear Anna

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

I am writing in response to the open letter issued on 20 December 2010. Thank you for giving us an extension to the deadline for a response..

We believe that in principle there should be a reasonable degree of protection against the IIS incentive for projects that are awarded LCN funding. As is recognized in the letter, if LCN funded projects are not protected from associated IIS penalties this may discourage schemes being put forward that may otherwise meet the LCN criteria and potentially provide benefits to customers across GB. We do not think that unplanned interruptions should necessarily be excluded. By their nature, LCN projects involve an element of testing, and may result in some unexpected interruptions to supply.

We agree with the principle that protection should be conditional on the DNO concerned demonstrating that the interruptions involved could not be reasonably avoided or mitigated, and that it should also provide Ofgem with a plan for how customers involved will be handled in the event that such interruptions arise.

Turning to the options for protecting LCN Fund projects from IIS penalties our comments are as follows.

Option 1: Project funding

For certain types of project it may be very difficult to make a robust estimate of associated IIS penalties, and this may in certain situations encourage a DNO to overbid the likely CI/CML impact. We therefore do not think that this option is likely to be generally applicable.

Option 2: Fund project IIS penalties through the discretionary reward

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This option would require the DNO to carry the risk that IIS penalties may be deemed 'unjustifiable' at the end of the project. In the absence of clear criteria at the outset, the DNO may consider that a project that involves a risk of significant IIS penalties is not worth putting forward for consideration. This could be addressed if there was a clear agreement at the outset about the nature of the risk involved and how the DNO proposed to deal with it.

Options 1 and 2 also incorporate the anomaly that all customers in the implementing DNO will receive compensation via the IIS at the expense of customers nationally even though only a small proportion of customers in the implementing DNO will have been affected by the supply interruptions.

#### Option 3: Exempt project interruptions from IIS penalties

We accept that this option – on which the previous statutory licence consultation was based – would eliminate the link between the IIS impact of a DNO's LCN project and reductions in charges to the DNO's customers resulting from that impact. On the other hand, it would remove an element of risk from the project for the DNO, and so make it less likely that otherwise worthwhile projects will be lost.

#### Possible hybrid option – 1 and 3

One way of limiting the risk to both DNO and customers would be to combine options 1 and 3. That is, the DNO would incorporate an estimate of the IIS impact of the project in its submission. This would add to the cost of its bid. However, in the event of the bid being successful there would be an exemption from IIS penalties up to the ceiling set out in the original bid. The DNO would therefore have an incentive to minimize the estimated impact of the project, while bearing the risk of IIS penalties where the ceiling in its bid was exceeded.

Overall we think that the hybrid option strikes an appropriate balance between encouraging projects to come forward, and spreading the burden of project costs, including IIS penalties, on the wider customer base that will benefit from dissemination of successful projects. We also believe that, since the projects that were approved for LCNF funding in 2010 contained a forecast of the implementation CI/CML, this option could be implemented both for the 2010 projects and those in future years.

I hope that this is helpful but please contact me if you would like to discuss.

Yours sincerely



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