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Decision and further consultation on the design of the Network Innovation Competition

Consultation

Reference: 113/11

Publication date: 2 September 2011

Response deadline: 17 October 2011

Contact: Anna Rossington

Team: Distribution Policy

Tel: 020 7901 7401

Email: anna.rossington@ofgem.gov.uk

Overview:

Innovation is a key element of the new RIIO (Revenue = Incentives + Innovation + Outputs) model for price controls. RIIO is designed to drive real benefits for consumers providing network companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a lower cost than would have been the case under our previous approach. Network companies will need to innovate to facilitate changes in the way networks are used, arising from the transition to a low-carbon, sustainable energy sector. Earlier this year we set out our proposals for encouraging this innovation, including a competitive funding mechanism, the Network Innovation Competition (NIC).

This document sets out our decision on non-network company access to funding under the NIC, following our consultation in January 2011. It also sets out a number of questions regarding the design of the NIC, which build on the decisions set out in the RIIO-T1 and GD1 Strategy Decision documents which we published in March 2011.

Context

Network companies will need to innovate to facilitate changes in the way networks are used, arising from the transition to a low carbon, sustainable energy sector. However they may be disincentivised from innovating where outcomes are particularly risky, or where they cannot realise commercial benefits. The new RIIO (Revenue = Incentives + Innovation + Outputs) model for regulating energy networks includes a range of measures designed to encourage innovation. One of these measures is the Network Innovation Competition (NIC). Funding will be provided by customers for projects which have the benefit to be rolled out across the networks – thereby benefitting all customers.

This document follows our open letter consultation on the Network Innovation Competition (NIC – referred to in the RIIO documentation as the innovation stimulus). It includes our decision on how to allow non-network companies to participate in the NIC, as well as a consultation on high level arrangements for the functioning of the competition itself. This consultation will inform our development of detailed proposals for the governance and workings of the NIC which we will publish in 2012, in time for the first competition in 2013.

Associated documents

- RIIO: A new way to regulate energy networks, Final Decision (ref. 128/10) http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf
- Handbook for implementing the RIIO model http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
- Decision on strategy for the next gas distribution price control – RIIO GD1 (ref. 47/11) (and associated documents) http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=312&refer=Networks/GasDistr/RIIO-GD1/ConRes
- Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Business plans, innovation and efficiency incentives (Supplementary Annex to Decision on strategy for the next transmission price control – RIIO T1 (ref. 46/11)) http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decisionbusplan.pdf
- Innovation stimulus open letter consultation (ref. 129/10) http://www.ofgem.gov.uk/Networks/nic/Documents1/Innovation%20Stimuli%20%2012102010%20Open%20Letterpdf.pdf
- Open letter consultation on non-network company access to innovation stimulus (ref. 07/11) http://www.ofgem.gov.uk/Networks/nic/Documents1/Open%20letter%20consultation%20on%20non-network%20company%20access%20to%20innovation%20stimulus.pdf

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Executive Summary

Gas and electricity network companies will play an important role in facilitating the move to a low carbon economy. They need to rise to this challenge while maintaining safe, secure and reliable energy supplies at long-term value for money to consumers. They will need to address issues such as connecting increasing volumes of intermittent generation and renewable gas sources without involving unnecessary network investment, for example by using more flexible equipment or operating practices, or encouraging customers to manage their demand. This means that network companies will need to innovate at an unprecedented rate.

We are currently implementing the new RIIO regulatory framework for the gas distribution and electricity and gas transmission sectors. Many elements of this new framework will encourage innovation, such as the focus on outputs and the longer-term, incentive-based price control which will reward innovation.

However, we recognise that research, development, trials and demonstration projects - the earlier stages of the innovation cycle - are speculative in nature and yield uncertain commercial returns, even within the new framework we have created. We are therefore establishing the Network Innovation Competition (NIC) as part of a time-limited package of measures to encourage the required step change in the level of innovation in the energy networks. They are designed to ensure that customers' money is spent addressing the key issues the energy network companies face as they consider what they should do to facilitate the transition to the low carbon economy and to ensure that learning is disseminated widely. This learning should benefit customers by improving the companies' ability to deliver environmental outputs efficiently and effectively.

Under the NIC, partial funding for projects will be awarded annually through a competitive bidding process. We have signalled previously that the design of the NIC will adopt many of the principles of the Low Carbon Networks (LCN) Fund that we set up last year to fund innovation in the electricity distribution sector.

This consultation comprises two chapters. In chapter 1 we present our decision on providing non-network companies access to the NIC. This follows our statement of intent to provide non-network company access in the RIIO Handbook issued in October 2010[1] and open letter consultation in our further thinking on this issue published in January 2011.[2] In chapter 2 we describe our proposals on key design elements of the NIC. This builds on our decision, published in our March 2011 RIIO Strategy Decision,[3] on the elements of the NIC that needed to be defined in order for the companies to prepare their well justified business plans.

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[1] Handbook for implementing the RIIO model
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
[2] Open letter consultation on non-network company access to innovation stimulus (ref. 07/11)
http://www.ofgem.gov.uk/Networks/nic/Documents1/Open%20letter%20consultation%20on%20non-network%20company%20access%20to%20innovation%20stimulus.pdf
[3] Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Business plans, innovation and efficiency incentives

1. Decision on non-network company access to the NIC

Chapter Summary

In this chapter we set out our decision on facilitating non-network company access to the NIC, following our consultation on this topic in January.

Introduction

1.1. We consider that non-network companies[4] have a valuable role to play in driving innovation on the energy networks. Other parties in the energy supply chain will have views on how the networks can assist them to facilitate the low carbon future; entities such as local authorities may be carrying out complimentary projects; and there are likely to be important lessons on innovation and the design of projects that can be learned from other industries such as the telecoms and information technology sectors. We want to encourage a wide range of high quality network innovation ideas, and consider that the participation of non-network companies in the NIC will be important to achieve this.

1.2. In January 2011 we published an open letter[5] consulting on options for facilitating non-network company access to the NIC[6]. We set out that in common with the LCN Fund, NIC funding will require transfers of funds from network companies to companies awarded funding in the annual competition. However, under existing primary legislation, money raised from network companies through price controls can only be transferred to licensed companies. Without a licence, non-network companies cannot receive direct funding via this method, and are limited to joining partnerships or consortia led by network companies. In our RIIO Handbook[7] we outlined our intention to

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http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decisionbusplan.pdf

[4] In this document we refer to any party which is not a network operator as a non-network company. For example, this includes academic institutions, individuals, trade bodies, investors or any other entities which do not hold a network licence.

[5] Ofgem, 'Open letter consultation on non-network company access to the innovation stimulus', January 2011.

[6] In the open letter, we used the term innovation stimulus to describe the competition. As set out in the RIIO-T1 and GD1 Strategy Documents published in March 2011, we have now named the competition the Network Innovation Competition (NIC).

[7] Handbook for implementing the RIIO model

designate a new class of licence (an "innovation licence") to enable non-network companies to participate directly in the annual competition. However in the January open letter we considered the advantages and disadvantages of this proposal, and compared it against other ways in which non-network companies could become involved in the competition.

1.3. Following this consultation, we have decided that non-network companies should only be able to access NIC funding by collaborating with licensed network operators. If there is significant evidence that non-network companies are finding they cannot access funding via collaboration, we will again consider whether direct non-network company access to NIC funding would be an appropriate solution to facilitating non-network company participation in the NIC. We set out our basis for this decision below.

Consultation

1.4. Early discussions with some non-network companies suggested that the process of applying for an innovation licence might deter non-network companies from submitting proposals. We therefore consulted on three options for non-network company access to the NIC:

- Option 1 – non-network companies would be able to compete on the same basis as network companies for project funding from the NIC, by applying for an innovation licence. The competition for funding between network companies and non-network companies could increase the quality of submissions and range of innovation proposed, but could mean that the non-network company would need a relevant network licence which could be a deterrent to some organisations. This option would also require arrangements to be in place should network companies fail to offer fair and reasonable terms of network access to the non-network companies.

- Option 2 – non-network companies would be able to apply for NIC funding for projects which would not be carried out on a licensed network.[8] This would involve a more limited innovation licence than for option 1, and would not need the non-network company to obtain a network licence. This option would retain some direct non-network company access to the NIC but would not need obligations on the network companies to provide access to their networks.

- Option 3 – non-network companies would only be able to access NIC funding by collaborating with licensed network operators. Non-network

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http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf

[8] Part of the Gas Transmission System, Gas Distribution System, Electricity Transmission System or Electricity Distribution System.

companies would not need any licence to participate in the NIC via any such network-led collaboration. This option mirrors the arrangements currently in place in the LCN Fund. Experience in the first year of the LCN Fund suggested that collaboration between network companies and non-network companies could be successful and constructive. However, we recognise that this option relies on network companies being willing to enter into partnerships with non-network companies.

1.5. In the January open letter we set out that our preference was for option 2, as it appeared to provide a good balance between providing non-network company access and imposing proportionate regulatory burden on both network companies and non-network companies. It widens the scope of non-network company access to innovation, while seeking to build on the success of collaboration so far.

1.6. We received 20 responses to our consultation. These were split equally between network companies and potential non-network company NIC participants. Two non-network company representative bodies submitted responses on behalf of their members. We also discussed the options in the innovation working group – members of which include representatives of network companies, potential non-network company participants and industry bodies in the gas and electricity sectors.[9] A summary of responses is included in Appendix 2.

1.7. Eight network companies favoured option 3, while two favoured option 2. Non-network companies were more evenly split, with four preferring option two, four preferring option 3, while one favoured option 1. Another non-network company proposed an alternative option.

1.8. The one respondent (a non-network company) that preferred option 1 thought that non-network companies should be able to compete equally with network companies for NIC funding, to attract the broadest range of potential innovation. The same stakeholder expressed concern that in some areas network companies do not have the desire or capabilities to lead innovation, which could restrict new initiatives and limit benefits to customers. They did not consider licensing requirements to be a deterrent.

1.9. Four non-network companies and two network companies supported option 2. The non-network companies thought it would help them to develop consortiums without network involvement. They said that doing so could improve their prospects when approaching network companies. One of the network companies stressed that their support for this option is contingent upon submissions being required to have network input to maximise their applicability for networks.

[9] Further details of the Innovation Working Group can be found on our website at the following address: http://www.ofgem.gov.uk/Networks/nic/iwg/Pages/iwg.aspx

1.10. Four non-network companies supported option 3. Amongst these, consensus was that innovations developed without input from network companies would be more difficult to implement. Such projects would therefore be less likely to deliver their intended benefits than projects involving network companies. Eight network companies favoured option 3 and said that an innovation licence is unnecessary. They argued that their current approach to working with non-network companies is successful, with no evidence suggesting otherwise. Some network companies commented that letting non-network companies test their ideas on licensed networks could put network companies' safety and reliability outputs at risk.

Decision

1.11. We agree with the majority of stakeholders that option 1 has considerable drawbacks, not least the possibility that non-network companies would require a relevant network licence to comply with the requirements of the Electricity and Gas Acts.

1.12. To be eligible for funding, companies will need to demonstrate that their innovation projects impact on the operation of the network (because funding is provided by network customers). Most non-network companies thought that collaboration with a network operator is essential to ensure effective network innovation and to win NIC funding. Even if non-network companies could enter the funding competition alone, they considered that it may be difficult to demonstrate the impact of their innovation without network company input. We therefore think there is insufficient evidence to demonstrate that options 1 or 2 would significantly improve non-network company access or increase the volume or quality of ideas put forward.

1.13. Some non-network companies have argued that being able to compete directly for funding would improve their ability to negotiate collaboration with network companies. They argue that if non-network companies could win NIC funding this would give them negotiating power when talking to potential partners. However we think network companies are likely to consider a wide range of factors when deciding whether to collaborate with non-network companies. These could include the suitability of their networks or consistency with their own innovation strategy or business priorities. Therefore, we do not think that winning funding would necessarily help non-network companies to form collaborations, especially when there will be little material benefit to the network company. Furthermore, direct access to the competition would not necessarily help non-network companies win funding alone. Only fully worked-up proposals (including impacts on the networks) could enter the final stage of the competition. Absent a network company partner, non-network companies might therefore find it difficult to win funding even if they can access the competition.

1.14. In addition, if a non-network company receives funding through the NIC, recovering misspend expenditure could be more difficult than from a network company, because they have no ongoing regulatory relationship with Ofgem.

This would mean we would have to use fines (rather than adjustments to network company allowed revenues) which would go to HM Treasury rather than being returned to customers.

1.15. Both options 1 and 2 involve us creating a new form of licence, an innovation licence. Creating, maintaining and enforcing such a licence would require significant Ofgem resource, as well as non-network company resource to obtain and maintain these licences. We think that it is important that mechanisms to encourage innovation are proportionate, and that other less onerous measures could help non-network companies access funding, in most cases as much as an innovation licence.

1.16. For these reasons we do not think there is sufficient evidence to justify direct funding to non-network companies. We will therefore implement option 3 – non-network company participation by collaboration with network companies. We therefore do not need to create an innovation licence.

1.17. We have discussed this decision with our working group of stakeholders (including the non-network company that preferred option one). They broadly agree with our decision for the reasons set out above, and have assisted in the creation of measures to facilitate non-network company participation in the NIC. These measures are set out in the next chapter and in part aim to reveal the scale of the problem if non-network companies are finding they cannot get network partners. Should significant evidence of such a problem arise, we will again consider whether direct non-network company access to NIC funding would be an appropriate solution to facilitating non-network company participation in the NIC.

2. Key elements of the NIC

Chapter Summary

In this chapter we set out our proposals on several aspects of the NIC, including eligibility criteria, the competitive process and measures to encourage non-network company participation. We also set out our thinking on funding, intellectual property, risk protection and rewards, and invite comments.

Question box

Question 1: Do you agree with our proposed two stage evaluation process and evaluation criteria?

Question 2: Do you agree with our proposals for facilitating non-network company participation in the NIC?

Question 3: Do you agree that the transmission companies should raise the funding for the NIC, and that it should be borne by customers according to their network usage?

Question 4: Should network companies be funded to cover some or all of the preparation costs for submissions to the NIC? If so, is the Network Innovation Allowance (NIA) the best way to achieve this?

Question 5: Do you agree with our approach to learning and intellectual property (IP) generated by the NIC? If not, please indicate how these arrangements could be improved.

Question 6: Do you agree with our proposals to offer a successful delivery reward and protection against cost overruns?

Question 7: Do you agree with our proposal not to have an ex-post delivery reward or specific reward for commercial innovation?

Introduction

2.1. The NIC aims to encourage technological, operational, commercial and charging innovation relating to gas and electricity transmission and distribution networks. For a time-limited period, the NIC will offer partial funding to projects meeting the required criteria, through an annual competition. It aims to encourage the step change in innovation activity necessary to facilitate the low carbon future and environmental objectives. Many aspects of the NIC are based on the LCN Fund, which we created to provide innovation funding for electricity Distribution Network Operators (DNOs).

2.2. In our RIIO Strategy Decision document published in March 2011, we set out our decisions on the aspects of the NIC relevant to the network companies' business planning processes. These decisions are summarised below.

- Scope: two separate annual competitions, one for gas (transmission and distribution) and one for electricity. The electricity competition will be for transmission only until the end of the current price control for electricity distribution (2015) at which point the LCN Fund will be incorporated into the electricity NIC and the funding amount reviewed.

- Eligibility: projects with low-carbon or environmental benefits are eligible to compete in the NIC.

- Funding amounts – over the eight year price control period the following maximum amounts will be available:
  - £240m for electricity transmission projects
  - £160m for gas projects

  We also set out that the independent expert panel which will evaluate competing projects and provide recommendations to Ofgem can also recommend a review of the funding levels if they consider there is sufficient evidence that the amounts need to be increased. We also decided that the maximum amount available in each year will remain level across the price control period.

- Funding mechanism: network companies will be permitted to recover funds as 'fast money', recovered through network charges in the first year of the project.

- Partial funding: NIC will provide a maximum of 90 per cent of project funding.

2.3. In this document we are consulting on the remaining high level policy aspects of the NIC:

  - Competitive process and evaluation criteria
  - Facilitation of non network company participation
  - Funding
  - Learning and intellectual property
  - Risks and rewards

2.4. We will consult on the detail required to implement the NIC as part of the development of the governance framework, in 2012.

Competitive process and evaluation criteria

2.5. The NIC will adopt many of the principles applied in the LCN Fund,[10] which provides funding for innovation relating to electricity distribution networks through an annual competition. The LCN Fund competition follows a two-stage process, comprised of an Initial Screening Process (ISP) and a Full Submission stage.

2.6. In the ISP DNOs submit outline project proposals, which Ofgem assess (pass or fail) against defined criteria. This ensures that the project would be eligible for funding and prevents DNOs wasting development costs on ineligible projects. Projects which pass ISP can be submitted as complete proposals at the Full Submission stage. The ISP has proved to be a useful component of the LCN Fund process, giving us, and the industry, an early sight of forthcoming submissions (and any issues arising) and giving potential participants the confidence to invest in developing full proposals.

2.7. In the second stage of the LCN Fund competition, DNOs submit comprehensive proposals. An independent expert panel judges the proposals and makes recommendations to the Authority on which should be funded. The panel consists of five senior experts who bring knowledge and expertise covering energy network industries, environmental policy, technical and engineering issues, economics and finance, and consumer interests.

2.8. The Authority has the final decision over which projects (if any) are funded. We publish the decision at the start of December, in time for the network companies to include the funding in the calculation of their charges for the next regulatory year.

2.9. We consider that this process has worked well in the LCN Fund and therefore propose to use the same two stage process (ISP and Full Submission) for the NIC.

2.10. The NIC will fund projects which generate learning which facilitates a low-carbon energy sector or delivers wider environmental benefits. Projects at all stages of development prior to roll out will be eligible. Such projects could include commercial innovation, innovation in operational practices, new equipment, or the novel use of existing equipment.

2.11. We propose to use the criteria developed and in use for the LCN Fund as a basis for the NIC funding criteria. Below we set out the criteria which we

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[10] Full details of the LCN Fund process and governance arrangements are set out in the LCN Fund Governance Document (v.4) which is on our website at http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/LCN%20Fund%20Governance%20doc%20v%204.pdf

intend to apply to both the ISP and at Full Submission. As with the LCN Fund, we propose a threshold test for the ISP and comparative evaluation at the second stage competition. We propose that submissions will have to demonstrate that the projects:

- accelerate the development of a low-carbon energy sector and/or deliver environmental benefits
- have the potential to deliver net financial benefits to existing and/or future network customers
- have a direct impact on the operation of a network operator's licensed network
- create knowledge that can be shared across energy networks in Great Britain (GB) or create opportunities for roll out for a significant proportion of GB networks
- are innovative (ie not business as usual) and have an unproven business case where the innovation risk warrants a limited trial research, development or demonstration project to demonstrate its effectiveness. Network companies will need to demonstrate that the incentives within the price control period are not sufficient to justify the project.

2.12. As with the LCN Fund, at Full Submission the expert panel and Ofgem will also use additional criteria. These criteria will measure the extent to which projects:

- are relevant to current network requirements
- demonstrate a robust methodology and readiness for implementation
- involve other partners and external funding.

2.13. With respect to the criterion above referring to the involvement of other partners and external funding, we are minded to include an extra weighting for projects which partner with small and medium sized enterprises, "non-standard" non-network companies and new entrants. This is to facilitate non-network company access, and is explained more fully in the following section.

2.14. Whilst the criteria are focused on benefits and learning to the GB networks (since the funding is being provided by GB network customers), we will expect project owners to disseminate their project learning as widely as possible. We will therefore require companies to set out their plans for knowledge dissemination in their proposals.

2.15. Companies involved in the NIC will need to ensure that they comply with all relevant legislation, including competition, environment and consumer protection laws, purchasing requirements and any relevant European legislation.

2.16. We will set out the next level of detail for all the NIC criteria in a governance document which we will develop and consult on in 2012.

Do you agree with our proposed two stage evaluation process and evaluation criteria?

Measures to facilitate non-network company participation

2.17. As stated in our decision in the previous chapter, we think non-network companies have an important role to play in bringing new and innovative ideas to the energy networks and raising the quality of projects. Non-network companies with expertise in areas such as telecoms, smarter grids and sustainability can bring new ideas and ways of working to the industry.

2.18. We therefore think it is important that non-network companies are able to participate in the NIC. Given our decision not to allow non-network companies to have direct access to the funding competition, we have considered options to minimise any barriers to successful non-network company collaboration in NIC projects.

2.19. In the LCN Fund companies are incentivised to partner with non-network companies through one of the evaluation criteria. As set out in the previous section, we plan to use this criterion in the NIC. However we have concerns that the network companies could limit their collaboration to a small number of established partners, and potentially repeatedly submit projects in partnership with the industry incumbents. We think it is important to encourage a broader range of partners (in terms of size, location and experience) and are therefore proposing to weight the criterion referring to the involvement of other partners and external funding to encourage partnerships with SMEs, "non-standard" non-network companies and new entrants.

2.20. In consultation, non-network companies have highlighted two other potential problems. First, non-network companies may not be able to find network companies to support their ideas, despite potential benefits to customers. Second, network companies could use their bargaining power to pressure non-network companies into accepting unfavourable collaborations terms. We consider that there are mechanisms we can put in place to address the former, which we have set out below. With respect to the latter, it is not within our remit to oversee commercial contractual relationships between collaborating parties.

2.21. Any requirements that we introduce should be proportionate. The first year of the LCN Fund suggests that network companies are already collaborating effectively with third parties. There is little evidence that network companies are rejecting good non-network company ideas or failing to consider non-network company approaches. Nonetheless, this might reflect the lack of any route for non-network companies to indicate such a problem.

Options

2.22. We have considered two options to facilitate non-network company access:

- allowing non-network companies to enter the NIC at the ISP stage before finding a network partner or
- requiring the network companies to set up a collaboration platform.

2.23. Allowing non-network companies to submit proposals to ISP without a network company partner could have a number of advantages. Non-network companies might find it easier to find a network partner if they have passed ISP. This option may also reduce any risk of network companies rejecting innovative projects which could result in them earning lower profits since the project would have a high degree of visibility, and we would be very interested in network companies' reasons for non-collaboration.

2.24. However, there are significant drawbacks to this approach. Opening ISP to non-network companies would require that we consider each and every application in a formal process, which could be highly resource intensive. There is a risk that non-network companies will submit a large number of projects that will not satisfy the criteria set out in the previous section, or will not be technically viable. Stakeholder feedback indicates that collaborations are most productively formed at early stages of the innovation process and that starting collaboration discussions after ISP would be too late. Furthermore, network companies might not be able to collaborate on a project, even if the project has passed ISP, for example because of incompatibility with their own physical network characteristics or with their business strategy.

2.25. Our preferred option is to require network companies to set up a collaboration platform. This would provide non-network companies with a guaranteed route to constructive dialogue with network companies. Network companies would have an obligation to respond to any ideas raised through the platform, with Ofgem having visibility of these responses. We will require network companies to respond to requests via the platform within a set timeframe. We also think network companies should collectively issue guidance to non-network companies about the kind of information network companies need to be able to assess project proposals. Network companies should decide the appropriate level of information to give in their responses, but Ofgem will be able to view all requests and responses. Non-network companies would not be compelled to use the platform – since they may consider that they can successfully develop relationships without it.

2.26. The platform should highlight any problems (and non-network company dissatisfaction) with network companies' approach to collaboration. If network companies appear to be repeatedly rejecting good projects, or avoiding certain collaborations, we will challenge network companies to demonstrate why they have adopted their approach, and may introduce additional measures as required.

2.27. We think that the platform, if well publicised, could inform a wide range of parties such as entrepreneurs, academics, venture capitalists and other investors as well as non-network companies based internationally to participate, to maximise potential new ideas. We understand that some entities are considering establishing their own fora for non-network companies to exchange ideas and form collaborations, and to potentially provide matching and facilitator services. We see these as promising initiatives.

Do you agree with our proposals for facilitating non-network company participation in the NIC?

Funding

2.28. Funding for the selected LCN Fund projects is provided by all distribution companies, on the basis that successful innovation should have the potential to be adopted across all the distribution networks. Similarly, successful NIC projects will be funded by all network customers. The funding for winning projects will be raised by network operators through use of system charges, and transferred to the company implementing the project. The gas NIC and electricity NIC will raise and transfer funds separately, since money cannot be transferred between sectors.

2.29. We will amend network companies' allowed revenue terms through a funding direction, in which we will also set out the net amounts to be transferred. We will issue the direction following the completion of the annual competition, and will time the publication to provide network companies with sufficient time to calculate and publish their new charges.

2.30. Since the gas NIC will cover transmission and distribution (as will the electricity NIC after 2015), there is a question as to whether funding should be raised by the transmission companies, distribution companies, or a combination of both. We consider that transmission companies should raise the funds through their use of system charges. If the distribution companies raised the funds, charges would not apply to network customers directly connected to the transmission system. Seven per cent of peak electricity demand is directly connected to the electricity transmission system[11] and around 19 per cent of gas exit capacity is directly connected.[12] In addition, having the smaller number of transmission companies manage the fund

[11] We calculate this estimate based on NG data. Seven per cent is calculated on the basis of local peak demand. We think this is a more appropriate measure of directly connected capacity, given that local peak demand does not necessarily coincide with grid peak demand.
[12] We calculate this estimate based on NG data. Directly connected gas exit capacity accounts for 19 per cent of all capacity including GDNs, storage and interconnector exit capacity.

raising and transfer will be a much more efficient process. Funding for the electricity NIC would in any case need to be raised through transmission companies initially, since electricity distribution innovation funding will continue to be provided through the LCN Fund until 2015.

2.31. Funding requirements will also need to be allocated between the electricity transmission companies (there is only one transmission company for gas). The electricity transmission charging methodology is applied to aggregated allowed revenues of the three electricity transmission companies. **We invite the electricity transmission companies to propose how this can best be achieved within the existing charging methodology, ensuring that each of the three companies raise the appropriate amount of revenues.**

2.32. Funding requirements could be shared between customers in one of two ways; either equally on a per customer basis, or in proportion to their use of the network. We think customers who make greater use of the network are likely to have a greater share in benefits resulting from improvements to the network. Therefore, we propose that customers should bear the costs of NIC funding in proportion to their network usage. This means that the funding requirement can be recovered through the charging methodologies already in place.[13]

2.33. As with the LCN Fund, NIC funding will only be provided for elements of the project for which funding has not been allowed under the price control. The companies are encouraged to explore other sources of funding for their project, since this is one of the evaluation criteria.

2.34. Companies will need to implement projects in accordance with the governance set out in a NIC governance document (which will be developed next year) and a project specific direction. Any expenditure which does not comply with either the governance document or project direction will be recovered from the implementing company and returned to customers.

2.35. We recognise that the preparation of a high quality project proposal can be costly and time consuming. We are therefore considering whether network companies should be allowed to fund bid preparation costs through their Network Innovation Allowance (NIA).[14] An alternative is that companies include the costs of preparation within the proposal – meaning that the costs only get funded if the project is selected for funding (a common model in other funding mechanisms). However we recognise that the network

[13] Network charging methodologies are in principle designed to reflect the cost each user places on the system.

[14] A fixed, limited, company specific annual allowance which provides each company with use-it or lose-it funding for smaller scale innovation projects. In the LCN Fund, companies are allowed to use up to 20 per cent of their First Tier funding to finance bid preparation for the Second Tier projects.

companies are operating in a regulated environment, and are inherently low risk - and therefore consider that by not providing funding we may disincentivise companies from participating in the NIC, or result in them submitting poor quality proposals. We consider that any funding through the NIA should be capped.

Do you agree that the transmission companies should raise the funding for NIC, and that it should be borne by customers according to their network usage?

Should network companies be funded to cover some or all of the preparation costs for submissions to the NIC? If so, is the NIA the best way to achieve this?

Learning and intellectual property

2.36. We expect all network companies to apply the learning arising from NIC funded projects (where appropriate). The incentives within the RIIO price controls should encourage network companies to use the learning to introduce new practices or reduce their costs. Some learning will deliver commercial returns to the company and should be implemented as soon as possible. We have also set out our decision to introduce opportunities within the RIIO-T1 and GD1 price controls to for companies to apply for funding for the roll-out of successful innovation – where it is not commercially viable within the price control period for the company to roll it out itself. At subsequent price controls we consider the impact of NIC learning, comparing practices and costs. This will give us the opportunity to consider how to treat any companies that have been slow to apply learning already adopted by others. Costs which could have been avoided by applying learning generated by NIC will not be funded in the RIIO-T2 and GD2 allowances.

2.37. The registration of intellectual property on an idea or mechanism restricts how others can use it – usually requiring them to purchase a licence. Since this could restrict the dissemination of learning from a project, in the LCN Fund we set a default condition that intellectual property (IP) rights generated by projects funded through the LCN Fund have to be shared between the other distribution network companies free of charge. Nonetheless, project submissions can propose alternative IP arrangements, should these be more appropriate. We propose to apply the same treatment to the NIC. Clearly any alternative treatment that restricts the dissemination of learning from a project could make that project less attractive for funding – and the project benefits would need to be worthwhile. It is possible that non-network companies may want to ring-fence their IP, or provide specific funding for project elements that may generate IP relevant to their work.

2.38. Any royalties gained by network companies from IP funded by the NIC will be shared with customers. Customers will have funded up to a maximum of 90 per cent of the creation of these royalties and so should receive an equivalent share. Similarly, if a company transfers the IP rights generated by NIC to other parties, they will be obligated to realise its value and share this with customers.

2.39. We have highlighted the importance of learning for the NIC, and so will set out in the governance document further conditions to ensure learning generated through the NIC will be shared widely. We will use experience gained under the LCN Fund as a basis.

Do you agree with our approach to learning and IP generated by the NIC? If not, please indicate how these arrangements could be improved.

Risk and rewards

2.40. Innovation, by its nature, involves risks and the possibility of a project not delivering the anticipated outcomes, or costing more (or less) than anticipated. In a commercial environment, companies undertake those projects where they assess the upside commercial benefits to outweigh the potential risks. In the regulatory environment, companies have less opportunity to make significant profits that they can balance against the risk of the project not being successful. We recognised this in the design of the LCN Fund and provide a limited risk protection and a reward.

2.41. LCN Fund participants can apply for funding to cover cost overruns of up to five per cent of the project cost (but are then unable to apply for a successful delivery reward, discussed later in this section). We consider that this is an appropriate protection, and propose to include the same mechanism in the NIC.

2.42. In the LCN Fund we also provide some protection from the non realisation of project benefits, where those monetary benefits were netted off the amount requested from the LCN Fund. We identify two forms of "direct benefit" - expenditure which has been already allowed under the price control and will be avoided or replaced through the project, and revenue generated by incentive performance improvements. These direct benefits, and their protection, will be reviewed as part of the second year review of the LCN Fund which will take place at the end of this year. We will base our decision on the protection of project benefits under the NIC on the outcomes of that review.

2.43. In an unregulated environment companies have incentives to deliver innovation projects efficiently, because their shareholders bare the cost and they want to deliver the innovation benefits as quickly as possible. The network companies will not have the same incentives, especially since the project funding is provided up front. To incentivise delivery the LCN Fund includes a successful delivery award of up to ten per cent of project funding (equal to the minimum DNO funding requirement). We pay this reward to DNOs which achieve milestones agreed as part of the project funding. Where companies apply for the cost protection described above, that cannot receive any reward for successful delivery.

2.44. Stakeholders at our IWG have expressed the importance of a successful delivery reward as a driver for efficient project delivery. We therefore propose to include a successful delivery award of ten per cent of project cost[15] as part of the NIC. Projects subject to applications for cost protection will not be eligible for this reward.

2.45. Participants in the LCN Fund can also apply for an ex-post discretionary reward, awarded to stand out projects after they have been completed. This reward is intended to provide an additional incentive for DNOs to fulfil the wider objectives of the LCN Fund and to outperform against expected learning outcomes. Feedback from our working group indicates that this ex-post reward does not influence behaviour of participants and potential participants, since it is uncertain and not linked to specific deliverables or objectives. Consequently we are currently proposing not to include any ex-post discretionary reward in the NIC. However, we may consider it necessary to introduce the discretionary reward at a later date if we think that additional incentivisation is required and justified. If this is the case we will consult on our proposals at the time.

2.46. In the RIIO handbook we outlined our intention to offer rewards specifically for commercial innovation. However, we now do not think this is necessary. Multiple LCN Fund submissions so far have included some element of commercial innovation and we consider that the same will be the case for the NIC. We therefore do not think it necessary to include any specific reward for commercial innovation. However we recognise that it is therefore vital that the criteria used to evaluate projects can properly accommodate commercial innovation, to ensure such projects enter the Full Submission on equal terms with innovation projects.

2.47. The funding for our proposed risk protection measures and rewards will come from the total amount of funding available, set out in the introduction to this chapter. Since the successful delivery reward and risk protection measures are mutually exclusive, we propose to set aside ten per cent (the maximum that could be awarded in total) of the funding amounts to cover these elements. This equates to £24m in electricity transmission and £16m in gas transmission and distribution over the eight year price control. The remainder is used for funding projects – meaning that projects can be funded up to an annual limit of £27m p.a. in the electricity NIC and £18m p.a. in the gas NIC. As set out in paragraph 2.2 the independent expert panel can recommend a review of the funding levels if they consider there is sufficient evidence that the amounts need to be increased.

Do you agree with our proposals to offer a successful delivery reward and protection against cost overruns?

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[15] This is ten per cent of the total of the funding provided from the NIC and the funding provided by the implementing network company.

Do you agree with our proposal not to have an ex-post delivery reward or specific reward for commercial innovation?

Implementation and timetable

2.48. We will issue our decision on this consultation in the autumn of 2011.

2.49. The NIC will be introduced as part of the RIIO-T1 and RIIO-GD1 price controls. We will therefore be developing the following before the start of the price controls in April 2013:

- Licence conditions which will allow companies to raise the funding and set the legal framework of the governance arrangements
- A governance document to provide detailed criteria for the competition, guidance on obligations and requirements on participants in the NIC.

2.50. The licence conditions are currently being drafted in conjunction with an industry working group as part of the RIIO-T1 and RIIO-GD1 licence modifications. We will issue consultations on all the price control modifications next year.

2.51. We expect to develop the NIC governance in 2012. This will give participants in the first year of the competition (2013) sufficient advance notice of participation requirements. If the same timetable is used for the NIC as with the LCN Fund, full proposals would be submitted in the summer of 2013, with winning projects announced at the end of 2013 for implementation in 2014. However some stakeholders have asked if this process can be accelerated in order that the winning projects can start in 2013. We are currently considering whether there are any feasible options for this.

Appendices

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 17 October and should be sent to:

- Neil Copeland
- Distribution Policy
- Ofgem, 9 Millbank, SW1P 3GE
- 0207 901 7401
- neil.copeland@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, in autumn 2011 we will publish a final decision on these issues. Any questions on this document should, in the first instance, be directed to:

- Neil Copeland,
- Distribution Policy
- Ofgem, 9 Millbank, SW1P 3GE
- 0207 901 7193
- neil.copeland@ofgem.gov.uk

CHAPTER: Two

Question 1: Do you agree with our proposed two stage evaluation process and evaluation criteria?

Question 2: Do you agree with our proposals for facilitating non-network company participation in the NIC?

Question 3: Do you agree that the transmission companies should raise the funding for the NIC, and that it should be borne by customers according to their network usage?

Question 4: Should network companies be funded to cover some or all of the preparation costs for submissions to the NIC? If so, is the Network Innovation Allowance (NIA) the best way to achieve this?

Question 5: Do you agree with our approach to learning and intellectual property (IP) generated by the NIC? If not, please indicate how these arrangements could be improved.

Question 6: Do you agree with our proposals to offer a successful delivery reward and protection against cost overruns?

Question 7: Do you agree with our proposal not to have an ex-post delivery reward or specific reward for commercial innovation?

Appendix 2 – Summary of responses to January open letter consultation

Introduction

1.1. On 21 January 2011 Ofgem published an open letter on non-network company access to innovation stimulus funds now known as the Network Innovation Competition (NIC). This letter consulted on three options for non-network company access to NIC.

- Option 1 – non-network companies can compete on the same basis as network companies for project funding from the NIC through applying for an innovation licence.
- Option 2 – non-network companies can apply for project funding from the NIC where the project is not carried out on a licensed network (ie it is an off-network project). This would involve applying for a more limited licence.
- Option 3 – non-network companies can only access the NIC through collaboration with licensed networks operators. Third parties would not require any licence to participate in the NIC via a network-led collaboration.

1.2. Nineteen responses were received in total. Nine from non-network companies, ie potential non-network companies and ten from network companies. Twelve respondents favoured Option 3 and five respondents favoured Option 2. One respondent favoured Option 1.

Non-network company preferences

1.3. Most non-network companies favoured Option 3 (collaboration only) with option 2 a close second (direct access for off-network projects). Two respondents did not state a preference. Only one non-network respondent stated a preference for option1.

1.4. Two respondents supporting option 2 felt that this option would extend funding opportunities to non-network companies and allow consortiums to be developed independently of the network operator. One respondent felt this would lead to greater innovation and speed of delivery. Another respondent saw this as an opportunity for non-network companies to develop and bring ideas to network companies for trialling and testing once the initial innovation project had been completed. Another thought that this approach would provide network companies with increased confidence to deploy non-network company innovations on their networks. One respondent noted that requiring non-network companies to apply for a licence could act as a disincentive unless the administrative overhead was kept to a minimum.

1.5. Non-network respondents in support of option 3 thought that unless network operators supported innovation it would not be implemented. A number of respondents agreed that strong cooperation with network operators early in the project increases the chances of implementation through better project definition and ensures the project is practical and relevant. It also felt that there was a lack of evidence to suggest that collaboration wasn't already working well. One respondent felt that even off network projects would benefit from network support. This respondent cited analysis of operational data, modelling of demand side response and tariff arrangements as areas where contributions from one or more network operators would be required to deliver real value.

1.6. A representative body with a membership of around 200 noted that there appeared to be little appetite from its members to become a licensed entity. Another respondent was concerned that Ofgem is proposing to increase the regulatory burden for all parties interested in innovation without evidence to support the contention that such a change is needed.

1.7. Another respondent was unsure of the extent of projects that Ofgem would consider to be off network, in particular whether projects that are on private or demonstration networks would be eligible for funding. This respondent also suggested that Ofgem may wish to consider making a proportion of innovation funding available for 'softer' challenges such as business and cultural changes, training personnel, amending and approving relevant documentation and developing robust business cases. The respondent felt that it is often these challenges that present the greatest hurdles to the adoption of new technologies, techniques and solutions.

1.8. One respondent, a trade association with a membership of over 700 encouraged Ofgem to pursue option 1. They felt that genuine innovation is best served by an open, level playing field where participants are not disadvantaged through their non-network status. The respondent accepted the need for oversight in terms of adherence to regulation. They also acknowledged the security and safety issues raised by network operators and maintained that these should always remain an absolute pre-requisite. However they felt that any such concerns could be assessed by the expert panel and the network operator in question.

1.9. The same respondent thought that option 3 raised serious concerns because it places responsibility for innovation squarely on the shoulders of network operators. They also questioned network operators' capabilities to lead innovation in areas such as software development. The respondent favoured option 2 over option 3 but felt this option threatens to create a disconnection between various technological innovations which will have a bearing on the energy system as a whole.

Network company preferences

1.10. Most network companies supported option 3. A number of the respondents felt that there is no evidence to suggest that collaboration isn't already working, as demonstrated in the LCN Fund and the Innovation Funding Incentive (IFI). Four respondents stated that it was unlikely that network companies would not support credible innovation. A clear area of concern was how network operators would maintain their responsibility to ensure the efficient and safe running of networks where non-network companies were granted access to their networks without their support.

1.11. A number of respondents noted that under option 2 there is a risk that without network support there is an increased likelihood that projects would not be successful and/or provide useful learning. One respondent argued that even off-network projects could potentially impact or conflict with energy flows and would therefore benefit from network support. Two respondents commented that the level of complexity and increased regulatory burden that would need to be applied to provide direct access for third parties was a concern especially when the need is not evident. However another respondent noted that unless third parties are subject to the same drivers and incentives as licensed operators there is a risk that customers could be adversely impacted, eg through reduced quality of service.

1.12. One network company questioned whether a licensing arrangement is practical or attractive for small scale operators (particularly as the innovation stimulus package is intended to be time limited). The respondent also noted that the arrangements required to secure the financial stability/visibility of third parties before they are eligible to receive funding may place constraints on the size/type of organisation able to qualify for a licence. A further point raised by the respondent was that the licence should not grant third parties any rights that would place networks in breach of any of their obligations (which are imposed by legislation).

1.13. Two network companies supported option 2. One respondent stated that networks do not have a monopoly on new ideas and that opening up innovation to third parties would attract a wider range of participants. They did however caveat that this option would still require non-network companies to demonstrate their ability to undertake projects on networks in partnership with network operators. The other respondent noted that the value of collaboration however they stressed that care should be taken to maintain a balance between the desire to promote solutions through competition and the driver to seek beneficial collaboration. This respondent also felt option 2 may require some kind of mechanism which would bring non-network companies and network operators together to collaborate. However they felt that the LCN fund could provide valuable learning in this area.

Further ideas for collaboration

1.14. Two alternative options were proposed by two non-network companies. One option was a hybrid approach whereby projects below a published threshold could be developed by a non-network company. These projects could follow one of two routes.

The first route allows network companies to hold a proportion of the NIC which they can use to support projects from non-network companies either individually or in conjunction with other networks. The second route requires non-network companies to submit proposals to Ofgem on a slimmed down basis to reflect the nature of funding available. All proposals must be endorsed by one or more network companies to demonstrate a market need for the proposed innovation.

1.15. Eligible projects would not require the same level of collaboration as under option 2 but would have to justify the potential benefit of the project to the network company. Non-network parties would be required to brief their sponsoring network on the need of the project and the progress throughout, possibly with key milestones being signed off by the network company as part of the reporting to Ofgem. This approach would minimise the time requirements for network companies to supervise and manage smaller and/or earlier stage projects but ensure there is a direct connection between the needs being experienced by the network companies and the innovation project.

1.16. The other alternative proposed was that of a two stage competition. The first stage is open to all comers - open competition or a call for a specific technology. Applications at this stage should be brief. The expert panel would shortlist applicants who are then required to find a network company to work with. Short listed applicants may also be allocated funds to help prepare their final bid in co-operation with a network partner. In the second stage final bids are submitted but only if third party has a network partner. The expert panel decides the winners.

1.17. This system opens up competition to the widest range of innovation. The lightweight first stage encourages many to participate. The innovator does not require a licence. The system prevents network companies from stifling innovation and keeps the work done by the network to a minimum. Once on the short list the innovator has the power to negotiate with the network. Network companies keep control of risks to the operation of their network.

1.18. Additional ideas to encourage collaboration from non-network companies included a 'collaboration matrix' included in the project assessment criteria to encourage collaborative submissions; the inclusion of more favourable intellectual property positions and simplification of the selection and approval process.

1.19. One network company suggested that a way to enable non-network companies to take a greater stake in innovation projects would be to allow them to contribute to part of the compulsory contribution. A contrary view to this was made in a response by a non-network company. Their view was that in order to ensure that network operators are clearly accountable for the innovation on their network they should not be incentivised to seek partners on the basis of their willingness to absorb a significant portion of the operational costs of funding bids.

1.20. Three network respondents thought that option 3 could be bolstered with additional obligations on network companies to ensure non-network companies have every opportunity to collaborate with network companies.

1.21. Both network and non-network companies thought that a formal appeals process would encourage network companies to collaborate with non-network companies.

Appendix 3 - Glossary

A

Authority/Ofgem/GEMA

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

B

C

D

Distribution Network Operators (DNOs)

Holders of electricity distribution licences. Licences are granted for specified geographical areas. Currently in Great Britain there are six corporate groups owning the fourteen licensed distribution areas.

E

Electricity transmission system

The system of high voltage electric lines providing for the bulk transfer of electricity across GB.

F

G

Gas Distribution Networks (GDNs)

Holders of gas transporters licences owning distribution system networks. Currently in Great Britain there are four corporate groups owning eight licensed distribution areas.

Gas and Electricity Markets Authority (GEMA)

(See the Authority/Ofgem/GEMA)

Gas Distribution System

The distribution system is a network of pipelines operating at pressures below seven bar, transporting gas from the local transmission system (LTS) and delivering it to domestic, commercial and industrial gas consumers.

H

I

J

K

L

Licence conditions (obligations)

An obligation placed on the network companies to meet certain standards of performance. The Authority (GEMA) has the power to take appropriate enforcement action in the case of a failure to meet these obligations.

Low carbon economy

An economy which has a minimal output of greenhouse gas emissions.

Low Carbon Networks Fund (LCN Fund)

A mechanism introduced under DPCR5 to encourage the DNOs to use the forthcoming price control period to prepare for the role they will have to play as GB moves to a low carbon economy. The fund will see up to £500m made available for DNOs and partners to innovate and trial new technologies, commercial arrangements and ways of operating their networks.

M

N

O

Ofgem

(See the Authority/Ofgem/GEMA)

Outcomes (objectives of new regulatory framework)

What the network companies are expected to deliver. The outcomes that we expect from the new framework are that network companies play a full role in the delivery of a sustainable energy sector and deliver value for money network services for existing and future consumers.

Outputs

Output information is to be used to assess network company performance against the outcomes within a control period. This information may be both qualitative and quantitative in nature.

P

Q

R

RIIO (Revenue = Incentives + Innovation + Outputs)

Ofgem's new regulatory framework, stemming from the conclusions of the RPI-X@20 project, to be implemented in forthcoming price controls. It builds on the success of the previous RPI-X regime, but better meets the investment and innovation challenge by placing much more emphasis on incentives to drive the innovation needed to deliver a sustainable energy network at value for money to existing and future consumers.

RIIO-GD1

The price control review to be applied to the gas distribution network operators, following GDPCR1. This price control would be expected to run from 1 April 2013 and will be the first transmission price control review to reflect the new regulatory framework, RIIO, resulting from the RPI-X@20 review.

RIIO-T1

The price control review to be applied to the electricity and gas transmission network operators, following the TPCR4 rollover. This price control would be expected to run from 1 April 2013 and will be the first transmission price control review to reflect the new regulatory framework, RIIO, resulting from the RPI-X@20 review.

S

Stakeholder

Stakeholders are those parties that are affected by, or represent those affected by, decisions made by network companies and Ofgem. As well as consumers, this would for example include Government and environmental groups.

Sustainable energy sector

A sustainable energy sector is one which promotes security of supply over time; delivers a low carbon economy and associated environmental targets; and delivers related social objectives (eg fuel poverty targets).

T

Transmission Owners (TO)

Companies which hold transmission owner licenses. Currently there are three electricity TOs; NGET, SPTL and SHETL. NGG NTS is the gas TO.

U

V

W

X

Y

Z

Appendix 4 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk