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Dear Neil,

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

SSE and Scotia Gas Networks welcome the discussion and debate that Ofgem has promoted over the recent months regarding the funding of innovation by network companies. I am pleased to provide our thoughts in relation to the latest consultation on the design of the Network Innovation Competition.

In light of our experience with the Low Carbon Network fund, we are largely supportive of the intention to take a similar approach in transmission and gas distribution. We do have two particular concerns that we believe merit further consideration. Firstly, we do not believe it is appropriate to introduce extra weighting for projects that partner with certain organisation types and that favouring one type of partner over another may have unintentional consequences. We propose instead that network companies demonstrate why they have selected the partners chosen.

Secondly, we are concerned that there is a lack of clarity surrounding the current *ex post* delivery reward as part of the Low Carbon Network fund. If Ofgem intends to continue with a similar approach in the Network Innovation Competition then we believe there needs to be greater clarity as to when a delivery reward will be made. As an alternative approach, we suggest that network companies submit an annual report detailing the adoption of innovative activities as part of business as usual across their networks and an *ex post* discretionary award scheme is used to reward adoption of learning on the basis of such reports.

We hope this response provides helpful input. If you have any queries or comments, please feel free to contact me on the details above.

Yours sincerely,

Aileen McLeod
Head of Network Regulation.

**CHAPTER TWO**

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

   Yes. We agree that this two staged approach has been effective in 'screening' proposals under the Low Carbon Network fund and see no reason why this same approach should not be applied to the NIC.

   However, we are less supportive of Ofgem's proposal to introduce an extra weighting for projects that partner with small- and medium-sized enterprises, "non-standard" non-network companies and new entrants. We would argue that experience to date demonstrates that the network companies are open to partnership ideas and we believe it would be a mistake to introduce an 'incentive' that was designed to favour one type of partner over another. We believe a more appropriate approach would be to ask network companies to demonstrate why any partners that they do choose to work with are the "right" ones.

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

   We agree with Ofgem's decision to adopt option 3, i.e. involving non-network company participation through collaboration with licensed network operators, and to lend support to this approach through a 'collaboration forum'. This builds on arrangements like the Energy Innovation Centre (EIC) model that are already in place to promote third party engagement and involvement.

   However, in terms of how this collaboration forum would work in practice, we believe more work is needed. We do not believe, for example, it is necessary to place an obligation on licensed network companies to respond to any ideas raised through the platform. Where there is a potential 'fit' between a network company and third party, we believe this interaction will happen automatically. Also, in any case, we struggle to see how an obligation would work in practice given that the collaboration forum would be an open forum across all network companies.

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?**

   We understand the rationale behind the approach proposed and agree that, on the face of it, it seems sensible for transmission companies to 'raise' the funding and to weight customers' costs according to their network usage and thereby ensure that transmission-connected parties pick up their share of the costs. However, we would like to see more detail on the workings of this proposal following the completion of Project Transmit.

   We note the concern that electricity TOs do not recover directly from customers and the suggestion that DNO costs would need to be allocated to a TO. However, the current TNUoS model treats allowed revenue in its totality, rather than by TO. We therefore propose that innovation funding is collected by the respective SO and distributed to the relevant licensee, either in line with a pre-determined allowance (for the NIA) or upon award (for the NIC). This approach should prevent the double-handling of funding and minimise any risk of confusion in the process. This approach will also need to be reviewed in light of the completion of Project Transmit to ensure it is still viable.

Separately, we have provided Ofgem with a number of examples where potential opportunities exist to trial cross-sector (gas and electricity) innovation. Whilst we recognise the challenges in terms of how cross-sector project costs could be recovered, we believe there is real merit in exploring this issue further. We would not want to see it ruled out at this stage. In a lot of cases, a demarcation between project elements will be possible but this may not always be the case. Without formal recognition of collaborative gas and electricity projects, then the potential uncertainty as to how such projects will be treated may deter the development of such projects.

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?**
   For the reasons set out in Ofgem's consultation document, we believe it is essential that appropriate allowances are made for network companies to be able to fund the preparation costs for submissions to the NIC. The cost to the SSE electricity distribution business of gearing up and submitting under the Low Carbon Network fund was c.£500 k. This is not an insignificant cost and, as such, allowances must be made to ensure that there are not disincentives to accessing the NIC.

   However, we question whether the NIA is the right means of funding these costs. The NIA is intended to cover smaller-scale innovation activities that are valuable in their own right but below the threshold that warrants developing a full NIC application. There is a risk that if development of NIC proposals is funded from this resource then it may detract attention from the development of these other projects that are likely to provide essential learning for future NIC projects.

   The size of funding under the NIA is determined by network size and therefore arguably penalises smaller network businesses, which will not necessarily incur smaller set-up costs. Moreover, as a result, the TO's scope to pursue R&D activities may be compromised. We believe it may be more appropriate to set aside part of the NIC fund to support the preparatory costs.

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.**
   The one concern that we would highlight would be in relation to the expectation that network companies apply the learning from NIC-funded projects. Importantly, this expectation should be in relation to 'relevant learning' only. We believe this is Ofgem's intent, but wanted to ensure clarity. Aside from this, the proposed approach is consistent with that of the Low Carbon Network. Timescales mean that this has yet to be tested, but the approach seems reasonable at this stage.

6. **Do you agree with our proposals to offer a successful delivery reward and protection against cost overruns?**
   The *ex post* delivery reward associated with the existing Low Carbon Network fund arguably lacks transparency. As a minimum, we would welcome greater clarity upfront regarding the criteria that dictate whether or not a successful delivery reward will be made under the NIC.

However, we believe a more appropriate approach may be to establish an *ex post* discretionary reward scheme whereby network companies prepare and submit, on an annual basis, a report detailing the innovative approaches adopted as business as usual across their network. Importantly, we believe this should be an opportunity for the networks to highlight all innovative activities that they have undertaken on their network, not just those funded through the NIC. Many innovations are naturally rewarded through Capex outperformance or CI/CML reductions. However, there are a broad category of innovations that have benefits outwith the normal reward mechanisms. Examples include speeding up the connection of EVs and MicroGeneration, and reducing the cost of customer connections. This award could be used to reward behaviours that are not purely focussed on inward focussed TO/GDN benefits.

7. **Do you agree with our proposal not to have an ex-post delivery reward or specific reward for commercial innovation?**
   See our response to Q6.