



To transmission companies,
distribution companies,
generators, suppliers, shippers,
offshore transmission owners,
customer groups and other
interested parties

*Promoting choice and value for
all gas and electricity customers*

Your Ref:
Our Ref: 02/12
Direct Dial: 020 7901 7194
Email: dora.guzeleva@ofgem.gov.uk

Date: 04 January 2012

Dear Colleagues,

Update and further consultation on design features of the Network Innovation Competition

In September 2011 we published our decision and further consultation on the design of the Network Innovation Competition (NIC)¹. In that document we considered, that at this time, there was no pressing need to have special arrangements to give non-network companies direct access to the NIC and that access would be best achieved through collaboration with network licensees². We also set out our proposals on the following design elements of the NIC:

- The competitive process and evaluation criteria;
- Measures to facilitate non-network company participation;
- Learning and intellectual property arrangements for projects;
- Risks and rewards to licensees awarded NIC funding; and
- The funding mechanism.

We welcome the responses we received to this consultation and today we have published these responses on our website alongside this letter.

Since the consultation closed, we have reviewed all the responses and further considered certain design aspects of the NIC. In this letter we raise a limited number of further questions on the NIC. We invite stakeholders to respond to these questions by **1 February 2012**. Please send your response to networks.innovation@ofgem.gov.uk

Background

Innovation is a key element of the new RIIO (Revenue = Incentives + Innovation + Outputs) model for price controls³. This new RIIO model will be applied to gas distribution companies (RIIO-GD1) and electricity and gas transmission companies (RIIO-T1) from 1 April 2013. It will be applied to electricity distribution companies (RIIO-ED1) from 1 April 2015.

¹ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=319&refer=Networks/nic>

² Network licensees include RIIO network licensees, ie those network companies that will be regulated through the RIIO T1, GD1 and ED1 price controls and non-RIIO network licensees ie those network companies that are regulated through another mechanism such as Offshore Transmission Owners and independent gas and electricity network operators

³ This replaces the old RPI-X price control framework. More information about the price controls can be found on [our website](#)

As part of RIIO, we proposed the Innovation Stimulus which consists of three measures: a Network Innovation Allowance (NIA); a Network Innovation Competition (NIC); and an Innovation Roll-out Mechanism (IRM).

The NIA is a set allowance that each of the RIIO network licensees will receive to fund small-scale innovative projects as part of their price control settlement. The NIC is an annual competition for funding larger more complex projects. The NIC will comprise of two competitions. One for gas and one for electricity. The NIA and NIC mimic the structure of the Low Carbon Network (LCN) Fund⁴ which consists of a First Tier allowance and a Second Tier annual competition for funding. The NIA is also similar to the Innovation Funding Incentive (IFI), introduced in previous price controls, to encourage innovation in the technical development of networks.

In developing the detailed governance for both the NIA and the NIC, we have consulted on a number of high level policy aspects of the NIC. Building on this consultation, we have considered two further specific issues that we would welcome views on, namely the:

- Breadth of network licensee participation in the NIC and the treatment of those licensees not regulated through the RIIO price controls; and
- Funding allowance for RIIO network licensees bid submission costs.

Network licensee participation in the NIC

The NIC will provide funding⁵ which the RIIO network licensees⁶ can bid for in order to develop innovative network projects which could deliver low carbon or environmental benefits for consumers. These are projects the RIIO network licensees would otherwise be reluctant to fund as they tend to be risk adverse and substantial returns from innovation are likely to be short lived and returned to the customer when new price controls are set.

The NIC is a key component of the RIIO-T1, RIIO-GD1 and RIIO-ED1 price controls. However, we would like to ensure that access to NIC funding is open to as many participants as is practicable in order to encourage good quality projects under the NIC.

In previous consultations, we considered non-network companies⁷ access to the NIC could be best achieved through collaboration with network licensees but left open the possibility for all types of network licensees to have direct access to the NIC⁸. In addition to the RIIO network licensees this could include licenced independent network operators (gas and electricity) and licenced Offshore Transmission Owners (OFTOs)⁹.

The breadth of network licensees participation in the NIC has not been specifically considered in previous consultations. Therefore, in this letter, **we are seeking views on how we should treat those network licensees that will not be regulated through RIIO price control settlements.**

In particular, we would welcome your views on the six considerations outlined below:

⁴ The LCN Fund is open to Distribution Network Owners (DNOs) and was introduced as part of DPCR5. More information on the LCN Fund can be found on [our website](#).

⁵ £30m per year available for the electricity NIC and £20m per year available for the gas NIC over the 8 year price control period.

⁶ This includes the following gas distribution and transmission companies: National Grid Gas plc, Northern Gas Networks Limited, Scotland Gas Networks plc, Southern Gas Networks plc, Wales and West Utilities Limited and the electricity transmission companies: National Grid Electricity Transmission plc, SP Transmission Limited and Scottish Hydro Electric Transmission Limited. DNOs will be eligible to enter the NIC at the start of RIIO-ED1 in 2015, when the LCN Fund will be incorporated into the electricity NIC.

⁷ To enable non-network companies/licensees to access funding we would need to designate a new class of licence (an "innovation licence").

⁸ Which includes RIIO network licensees and non-RIIO network licensees.

⁹ Termed non-RIIO network licensee for the purpose of this letter.

- i) **Appetite for entry:** We would like to understand the level of interest non-RIIO network licensees hold in the NIC. As such, we are interested in hearing from these licensees whether they are considering involvement in the NIC, either as a submission lead or as a collaborator in a submission led by another network licensee.
- ii) **Potential benefits:** We consider that including all network licensees in the NIC, and not just RIIO licensees, could encourage a wide range of high quality network innovation ideas and we are interested in views on other potential benefits in maintaining this breath of licensee participants.
- iii) **Meeting the evaluation criteria:** We outlined in our previous consultation in September 2011 our proposals for the high-level evaluation criteria which a NIC project must satisfy to be eligible for funding. These evaluation criteria apply the objectives of the NIC. Given this, we would welcome views on the ability of non-RIIO network licensees to submit bids that are likely to meet these criteria and thus fulfil the objectives of the competition. We note, for example, the requirement to submit innovative projects that have the potential to be rolled out across GB may be difficult to achieve for those non-RIIO network licensees who operate a relatively small, newly built section of network.
- iv) **Potential Barriers:** We would welcome views on any potential barriers that may exist to prevent non-RIIO network licensees entering the competition (where projects meet the high-level evaluation criteria we have set out). We would also welcome suggestions of potential solutions to such barriers where applicable.
- v) **Funding bid submission costs:** We are minded to allow RIIO licensees to recover reasonable bid preparation costs through the NIA¹⁰. This would not be possible for non-RIIO network licensees as the NIA is a RIIO specific provision. We are therefore considering the implications of introducing a separate mechanism to provide non-RIIO network licensees funding for reasonably incurred bid submission costs. We have some concerns that the incentives for non-RIIO network licensees to spend such funding efficiently may not exist in the same way it does for the RIIO network licensees. We would therefore welcome views on the appropriateness of funding bid submission costs for non-RIIO network companies.
- vi) **Halting projects:** A key element of the LCN Fund governance is the ability to halt projects and claw back misspent funding when required. For RIIO network licensees we would insert a claw back requirement into their licence for them to repay any misspent funds. Therefore, we will require non-RIIO network licensees who wish to participate in the competition to have the same condition inserted into their licence.

Funding RIIO licensees

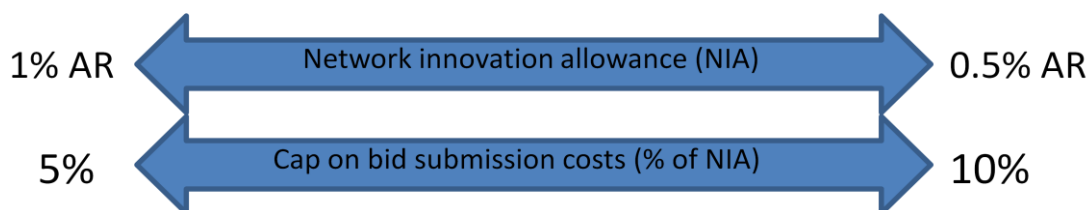
As part of the LCN Fund arrangements, each DNO may use a maximum of 20 per cent of its First Tier allowance for expenditure used to put in place the resources needed to progress innovative projects, including the costs of bids for the Second Tier competition. In our September consultation, we therefore asked whether a similar arrangement would be appropriate for the NIC, whereby a proportion of the NIA could be used to fund NIC bid submission costs.

If we use the NIA for RIIO network licensees we intend to apply a cap on the amount of NIA funding that can be spent on bid submission costs. Distribution Network Operators can

¹⁰ Most respondents to the September consultation supported using the NIA for funding some of the bid submission costs.

spend between approximately 0.3 and 0.5 per cent¹¹ of their annual Allowed Revenue (AR) on First Tier projects whereas the NIA will be set between 0.5 and 1 per cent of a RIIO network licensees' annual allowed revenues¹². As such, we consider the bid submission costs should be capped between 5 and 10 per cent of the NIA as this is consistent with the LCN Fund

The NIA may vary between 0.5 and 1 per cent of RIIO network licensees allowed revenues, therefore the total value of NIA funding will vary among licensees. This could result in some RIIO network licensees having access to a larger allowance than others to use for NIC bid submission costs, potentially distorting the opportunities available to some licensees. We have therefore considered introducing a "sliding cap" on the amount of NIA funding that can be used for bid submission costs, where we would vary the cap depending on the level of NIA funding received resulting in the equivalent proportion of a companies allowed revenues being spent on bid submission costs. We propose a sliding cap mechanism, where the value of the cap will vary proportionally between 5 and 10 per cent depending on the value of the NIA.



Do you agree with a sliding cap of between 5 and 10 per cent of the NIA to fund bid submission costs for RIIO network licensees?

Decision on high level policy elements

As stated above, we received 11 responses to our September decision and further consultation document. Before we make firm decisions on each of the topics above we would like to consider the responses to the questions raised in this letter. We have also recently launched the LCN Fund two year review¹³. We have previously signalled that the design of the NIC will adopt many of the principles of the LCN Fund and, where appropriate, we wish to consider the responses to the LCN Fund two year review when making our decisions on these high level policy aspects early next year.

Next Steps

We welcome responses to the questions we have raised in this letter by **1 February 2012**. Responses should be sent to networks.innovation@ofgem.gov.uk. Respondents who wish to have their responses remain confidential should clearly mark the documents to that effect and provide reasons. Unless marked confidential, all responses will be published by placing them on our website.

In the meantime we intend to hold an Innovation Working Group (IWG)¹⁴ meeting on **19 January 2012**, to discuss the questions raised in this letter and the next steps for developing the governance for both the NIA and NIC. If you would like to attend this working group meeting please contact networks.innovation@ofgem.gov.uk for further details.

¹¹ This varies on a licensee by licensee basis as First Tier expenditure is allocated based on customer numbers.

¹² The value will be set depending on the quality of their Innovation Strategy, which is submitted as part of companies well-justified business plans.

¹³ [http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/Low%20Carbon%20Networks%20Fund%20Two%20Year%20Review%20\(2\).pdf](http://www.ofgem.gov.uk/Networks/ElecDist/lcnf/Documents1/Low%20Carbon%20Networks%20Fund%20Two%20Year%20Review%20(2).pdf)

¹⁴ members of which include representatives of network companies, potential non-network companies' participants and industry bodies in the gas and electricity sectors.

Timing and implementation of the NICs

The NICs will be introduced as part of the RIIO-T1 and RIIO-GD1 price controls on 1 April 2013. In 2015, at the start of RIIO-ED1, the LCN Fund will be incorporated into the electricity NIC.

We intend to hold the first competition in 2013, with the winning projects receiving funding from 1 April 2014. In preparation for the first competition, we will develop the following before 1 April 2013:

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

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 later in the year.

We intend to develop the NIC governance document throughout 2012. We will develop the document with stakeholder input via the IWG and we will also use the learning from the recently launched LCN Fund two year review to inform our thinking where appropriate.

Should you wish to discuss the issues raised in this document, please contact Nicola Meheran at nicola.meheran@ofgem.gov.uk or on 020 7901 0515.

Yours faithfully,

Dora Guzeleva,
Head of Networks Policy: Local Grids