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Neil Copeland  
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17 October 2011

Dear Neil

### **Decision and Further Consultation on the Design of the Network Innovation Competition**

UK Power Networks is pleased to respond to Ofgem's decision and further consultation on the design of the forthcoming Network Innovation Competition (NIC).

UK Power Networks believes that the open nature of the consultation leading to Ofgem's decision, and in particular the Innovation Working Group forum which has carefully considered the relative merits of possible approaches to the NIC, has drawn out a high level of informative debate. In particular, this debate has been instrumental in Ofgem being able to reach a well reasoned decision in respect of non-network company access to the NIC and in determining where further consultation would be appropriate.

Experience gained to date through the Low Carbon Network Fund (LCNF) Tier 2 arrangements has been particularly helpful in informing the best way forward with regard to the NIC. It is therefore pleasing to note that the proposals put forward in this decision and consultation document have given full regard to this experience. Hence, if these proposals are implemented, the key elements of the NIC arrangements will broadly mirror the existing arrangements under LCNF Tier 2.

UK Power Networks' response to the decision and to each of the questions posed by the consultation is laid out in the Appendix and we have no objections to this response being published on Ofgem's website.

If you have any queries on this response, or if we can be of any further assistance on this topic, please do not hesitate to contact Dave Openshaw in the first instance.

Yours sincerely

Keith Hutton  
Head of Regulation

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## Appendix

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

The two stage evaluation process has been helpful in the first two years of operation of the LCNF Tier 2 (competitive) arrangements in providing early assurance to both DNOs and Ofgem that any projects under development are consistent with Ofgem's interpretation of eligibility as specified under the eligibility criteria.

The fact that, to date, no project submitted at the initial screening stage of the procedure has been rejected at that stage, might suggest that the initial screening process is superfluous. However, the process has a further benefit in highlighting to all participants the nature of the project proposals being put forward. This in turn permits DNOs to review their proposals in light of other projects being put forward and to consider whether either unnecessary duplication between respective DNOs' proposals is a possibility, or, alternatively, whether there may be gaps between respective proposals that might otherwise be complementary and provide for greater learning if those gaps were to be addressed. A further possibility is that DNOs might see an opportunity to collaborate with each other in the formation of their project proposals to ensure that, should both projects be awarded funding, then the overall learning would be further enhanced (i.e. the whole might be greater than the sum of the parts).

UK Power Networks therefore believes that the two stage process has merit; in particular, for Transmission Network Operators and GDNs, who will be entering into the competitive process for the first time in 2013 (or potentially earlier subject to a decision on whether it might be possible to allow projects to actually commence in 2013).

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

UK Power Networks agrees with Ofgem's proposals, the reasons for which are comprehensively articulated in the consultation document. Not only is there no evidence to suggest that DNOs have been reluctant to engage with non-network companies and small to medium enterprises, there is ample evidence within the LCNF first and second year proposals put forward by DNOs to suggest that such engagement is both actively sought and secured. Indeed the portfolio of LCNF Tier 2 proposals put forward to date has demonstrated a wide and imaginative range of collaborative partners drawn from various sectors including: local government, academia, telecommunications companies, systems integrators, energy retailers, commercial aggregators, demand side appliance manufacturers, and consumer engagement specialists.

UK Power Networks is convinced that the current arrangements under LCNF Tier 2 give rise to the greatest opportunities for non-network companies and SMEs to participate in collaborative partnerships. More importantly, the current arrangements provide for effective collaborations to be formed; innovative and meaningful project proposals to emerge; and for projects to be successfully delivered.

In summary, UK Power Networks supports Ofgem's decision to implement the option whereby non-network companies will have access to NIC funds only through forming a collaborative partnership with one or more licensed network operators (who will submit proposals for consideration of funding under the NIC procedures on behalf of the collaborative partnership), and funds raised through use of system charges will be directed only to licensed network companies.

**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?*

UK Power Networks considers that this is both a pragmatic and demonstrably fair way of raising money for transmission related projects. By this means transmission connected customers would contribute (through transmission charges and hence according to their usage) towards innovation which they might ultimately benefit from. There could be additional complications of apportionment should a TNO collaborate with one or more DNOs to form an NIC project proposal, or National Grid collaborate with one or more GDNs. However, provided the potential benefits of the project can be reasonably apportioned between transmission and distribution, with each partner contributing their share of the project costs accordingly, then apportionment should be relatively straightforward. It should be borne in mind, however, that transmission charges are in any case passed through to customers through energy bills. It follows that the main benefit arising from transmission companies raising funds is that transmission connected customers would then also contribute.

UK Power Networks' 'Low Carbon London' project will provide learning which might benefit customers connected to transmission networks, including renewable generators. While National Grid is a partner in this project, acting in their capacity as National Electricity Transmission System Operator, under the LCNF arrangements National Grid is unable to obtain funds through transmission charges. It follows that any move towards appropriate projects, or elements of projects, which benefit transmission networks and/or their connected customers being funded through transmission charges will permit a more equitable sharing of funding between those customers who are connected to distribution networks and those who are connected directly to transmission networks.

**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 the best way to achieve this?*

UK Power Networks believes that the arrangements currently in place for LCNF projects, whereby up to 20% of their LCNF Tier 1 allowance can be used to fund LCNF Tier 2 project bid costs, should be carried forward. It would follow that 20% of a network operator's Network Innovation Allowance (NIA) in any one year could be used to fund NIC project bid costs incurred in that same year. It would be reasonable, however, to stipulate that only projects meeting the eligibility criteria at initially the screening stage and ultimately the final submission stage should be permitted to recover costs through use of system charges and use NIA allowances to finance their NIC project bid costs. This should allay any concerns that customers could be at risk of funding the preparation of poorly specified projects which are ineligible for NIC funding and hence would not, even if awarded funding, deliver the required benefits to customers.

**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.*

The current arrangements under LCNF Tier 2 are generally operating satisfactorily and should therefore be carried forward into NIC. It should be borne in mind, however, that for small companies, in particular start-up companies, generated IP might be an invaluable outcome of the project that could secure the company's continuing prosperity and perhaps, in difficult times for the economy, even its survival. Moreover, the generation and right of retention of IP by a company could be the best guarantee of that IP being used to develop and commercialise products that network operators could then invest in to the benefit of their customers. Conversely, if the generated IP is to be shared, then such companies might be reluctant to participate in NIC projects with the result that the development and commercialisation of products is delayed or even precluded.

UK Power Networks supports the view that if non-network companies wish to ring-fence commercially valuable foreground IP gained through their participation in the project, then their participation in the project should still be considered positively provided their participation is entirely at their cost. Under those circumstances, the overall project proposals should be considered no less attractive for funding than any project which complied in all respects with the IP default arrangements.

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

UK Power Networks believes that a cost overrun provision of 5% of the project funded costs should be unnecessary (5% being within the range normally considered as an acceptable level of cost overrun risk for a network project which should be managed through contingency), particularly if selecting such protection disqualifies the company from then applying for a successful delivery reward. Nevertheless, UK Power Networks has no objection to that provision remaining for companies who might wish to consider that option.

On the question of successful delivery reward, UK Power Networks believes this is a strong incentive to not only prepare innovative and well planned projects, but also to ensure that successful delivery reward milestones are delivered on time through appropriate attention to project management. We therefore agree with the proposal to include a successful delivery reward of 10%.

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

While the possibility of an additional ex-post delivery reward would seem to be a further incentive to deliver successful projects, UK Power Networks is of the view that the possibility of the reward makes no practical difference to the amount of effort applied to achieving a successful outcome – not least because of the lack of clarity as to what objective criteria (above fulfilling the requirement to deliver successful delivery reward criteria milestones to time and cost) Ofgem would apply in deciding whether or not to make such a reward. Moreover, if there is a distinct possibility that no ex-post rewards are made, or that insufficient rewards are made to make full use of the provision set aside, then it would be better for that provision to instead be converted into available NIC funds.

On the question of a specific reward for commercial innovation: while UK Power Networks understood Ofgem's desire to ensure that DNOs gave due weight in their LCNF Tier 2 proposals to exploring commercial innovation as a potentially economically attractive alternative to non-network solutions, this perhaps underestimated DNOs' readiness and capability to embrace such alternatives. LCNF project proposals put forward to date have shown considerable appetite for commercial innovation, however commercial innovation for the sake of commercial innovation is clearly undesirable. What is important is the potential for innovation to deliver genuine efficiencies. Commercial innovation will not always be more effective than technological innovation and it therefore follows that no bias should be applied to commercial innovation; rather, innovation should be considered purely on its merits, with no discrimination between different categories. That said, commercial solutions will play an increasingly important role in the transition to a low carbon economy and it will therefore be important to ensure that the current commercial innovation impetus is maintained and reflected in future NIC project proposals.

UK Power Networks therefore agrees that no specific reward for commercial innovation need be included within the NIC proposals, but that this should be kept under review to ensure that the necessary evolution of commercial solutions to meet the challenges of low carbon transition are given due priority in future NIC project proposals.

**UK Power Networks**  
**17 October 2011**